Supreme Court, U.S.
FILED

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No.

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM 1997

THE ESTATE OF DAVID J. BRAUNSTEIN and ROSEMARIE BRAUNSTEIN, et al.,
Petitioners,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, et al.,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE COURT OF APPEALS
OF THE STATE OF NEW YORK

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

1. When monies (defined in the securities industry as "free credit balances") are held in a trust relationship by a securities broker (respondents who are also known as "broker-dealers" or "brokers") for its customers (petitioners) and such trust relationship as well as the duties flowing therefrom are recognized by the courts of the state where those monies are held and controlled, is there any federal regulatory scheme concerning "free credit balances" that by virtue of the Supremacy Clause (Art VI., cl. 2) of the United States Constitution preempts common law claims for unjust enrichment or breach of fiduciary duty as remedies against the trustee securities broker by the beneficiary of such trust, i.e. the customer, for unlawful gains obtained by the trustee from the use of such monies?

a. When a trustee holds, controls and uses its beneficiaries funds for the trustee's own purposes is there a federal statutory scheme established by Congress or the Securities Exchange Commission that provides any and all remedies for breach of that trust thereby preempting all claims against the trustee broker by virtue of the Supremacy Clause (Art. VI, cl. 2) of the United States Constitution or does the trustee broker have a state common law obligation to pay to the beneficiary any of the benefits inuring to the trustee from such use?

2. Does the complete absence of any federal standard or regulation governing the right to receive the benefits from the use of "free credit balances" (which are cash balances due upon demand by the customers from broker-dealers) by securities brokers (also known as "broker-dealers" or "brokers") acting as fiduciaries for their customers in regard to "free credit balances" evidence intent by Congress

or the SEC to preempt and extinguish by virtue of the Supremacy Clause (Art. VI, cl. 2) of the United States Constitution any and all common law rights and remedies of redress by customers of broker-dealers against those broker-dealers, such rights being expressly preserved and saved by §28(a) of the 1934 Securities Exchange Act (Act), 15 U.S.C. § 78bb(a) (1993) which provides that the Act's rights and remedies are "in addition to any and all other rights and remedies that may exist at law or in equity"?

a. Does the decision of the Court of Appeals of New York eliminating the common law remedies of unjust enrichment and breach of fiduciary duties as to free credit balances conflict with and exceed the authority of the savings clause of §28(a) of the 1934 Securities Exchange Act (Act), 15 U.S.C. §78bb(a) (1993), which saves state claims rather than preempts them as it provides that the Act's rights and remedies are "in addition to any and all other rights and remedies that may exist at law or in equity"?

PARTIES TO THE PROCEEDINGS

In addition to petitioners, Estate of David J. Braunstein and Rosemarie Braunstein, and respondents, Merrill Lynch, Pierce, Fenner & Smith, Incorporated, listed on the cover, the following petitioners (formerly plaintiffs-appellants) and respondents (formerly defendants-respondents) are parties to the appeal:

Petitioners: Neil Weiner; Burton Solomon; Sandra Mallien; Joann duPont; Philip Karp; Carolyn Goodwin as executrix of the Estate of Edith Camper deceased; Thomas McWhorter; William L. Norton; Rudolfo Ximenes; and Robert Sapinzon and Ruth Sapinzon, Trustees Sapinzon Family Trust, on behalf of themselves and all others similarly situated

Respondents: Prudential Securities Incorporated (Prudential); Smith Barney Shearson Inc. (Smith Barney); Kemper Securities Group Inc. and Kemper Securities, Inc. (Kemper); Dean Witter Reynolds, Inc. (Witter); Alex. Brown & Sons, Inc. (Brown); Bear, Stearns Securities Corp. (Bear Stearns); Charles Schwab & Co., Inc. (Shcwab); Kidder, Peabody and Co. Incorporated (Kidder); Painewebber Incorporated (PW); and Lehman Brothers, Inc. (Lehman)

All petitioners are individuals or fiduciaries for others who were the original plaintiffs as well as the appellants below. They each were customers of the respondent broker-dealers, defendants and appellees below. Each of the

petitioners maintained brokerage accounts[1] at one or more of the respondents' firms, all of which accounts held "free credit balances"[2] resulting from the trading activity of petitioners in varying amounts from several hundred to several thousand dollars (App. G, A66-78) upon which all benefits that were generated by those "free credit balances" were arrogated to their trustee broker-dealers, respondents here, leaving none of such benefits to inure to petitioners.

All respondents are brokerage firms (known in the securities industry as broker-dealers) and were named in the original complaint. They are in the business of trading securities with the funds and assets of petitioners as well as

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[1] Respondents stated in their sworn affidavits and moving papers that they maintained 30,000,000 accounts with customers such as petitioners. These declarations which when totaled as to the number of accounts nationally held by all respondents add to approximately 25,000,000 accounts and were made in court filings in the Arizona court where a predecessor action was filed, but stayed by respondents who argued successfully that New York was in their view the center of the securities industry (App. A, A1-24). Other moving papers filed by respondents and discovery brought this number closer to 30,000,000. See pp. 4-7 infra for explanation of prior proceedings.

[2] "Free Credit Balances" are defined by the SEC as "liabilities of a broker or dealer to customers which are subject to immediate cash payment to customers on demand, whether resulting from sales of securities, dividends, interest, deposits or otherwise." Rule 15c3-3(a)(8), 17 C.F.R. §240.15c3-3(a)(8) (1996) (App. B, A25). The Securities industry has changed such definition to mean assets - and free ones at that - available for unfettered use by the respondents.

distributing and/or accounting for funds such as dividends and interest due petitioners. These funds among others constitute "free credit balances" and come into respondents' possession for the benefit of petitioners. Respondents maintain and use millions, if not billions, of dollars of "free credit balances" daily (App. G at A63-64; App. Y at A208-209; App. CC at A230-234).

The names of all petitioners and respondents as contained in the caption of this petition and on page iv herein are the same as in the original New York Supreme Court complaint except that:

CHANGES IN THE ORIGINAL PARTIES:

Additional Plaintiffs (Petitioners)	Deleted Plaintiffs (Petitioners)
The Estate of David J. Braunstein and Rosemarie Braunstein;	David J. Braunstein and Rosemarie Braunstein, Joint Tenants;
Carolyn Goodwin as Executrix of the Estate of Edith Camper	Royal Towing/FBO David J. Braunstein Retirement Plan;
	David J. Braunstein, Trustee Royal Towing Inc. Pension Plan;
	Estate of Edith Camper;
	Paul Kahn Custodian for the Benefit of Michael Kahn

TABLE OF CONTENTS

QUESTIONS PRESENTED i

LIST OF PARTIES iii

TABLE OF CONTENTS vi

TABLE OF AUTHORITIES xiv

OPINIONS BELOW 1

JURISDICTION 1

STATEMENT OF THE CASE 2

Description of Proceedings Below 2

REASONS FOR GRANTING THE WRIT 7

A. The Writ Should Be Granted In Order To Correct The Palpable Conflicts Between The Legislative Purposes Of Section 28(a) (The Savings Clause) Of The 1934 Securities Exchange Act, 15 U.S.C. §78bb[a] (1993) Which Preserves All Common Law Claims Not Federally Preempted And This Court's Standards for Preemption as Applied By The Court of Appeals of the State of New York . . . 7

1. Neither Congress Nor the SEC Preempted Common Law Claims of Breach of Fiduciary Duty and Unjust Enrichment Against Broker/Dealers (Respondents) or Claims Regarding

Free Credit Balances by Their Customers (Petitioners); Section 28(a) Of The Securities Exchange Act Of 1934, 15 U.S.C. §78bb(a) (1993) Expressly Preserves Common Law Claims 8

2. The Supremacy Clause Does Not Preempt The Subject Claims For an Accounting Based Upon Breach of Fiduciary Duty and Unjust Enrichment 11

3. The Mere Existence of Some Federal Regulation Permitting the Use of "Free Credit Balances" Belonging to Customers of Broker-Dealers By Broker-Dealers Does Not Evidence Intent to Preempt State Regulation of State Law Claims for Redress by Customers of Broker-Dealers For Benefits Improperly Arrogated by Broker-Dealers to Themselves From Such Use As The Federal Regulations That Do Exist In Such Regard Were Enacted Only For Purposes Of Protecting Customer Funds And Securities Through The Establishment Of Rules For Preservation Of Broker "Net Capital Requirements" And Broker Liquidity 13

B. The Writ Should Be Granted Because The Importance Of The Federal Question At Bar Is Articulated By The Finding In The New York

Supreme Court That Securities Brokers (Respondents) Are Fiduciaries In Their Relation To Their Customers (Petitioners) Thereby Further Warranting Review By This Court As Respondents' Actions And Business Policies As Fiduciaries Affect Millions Of People And Billions Of Dollars 17

C. The Writ Should Be Granted Due To The Importance Of The Federal Question Arising When The Court Of Appeals Of The State Of New York In Its Affirmance Of A Lower Court Opinion Found That The Supremacy Clause Of The United States Constitution, Article VI, Clause 2 Federally Preempted All Common Law Rights Of Redress For Breach Of Fiduciary Duty And Unjust Enrichment By The Customers (Petitioners) Of Securities Brokers (Respondents) Against Securities Brokers For Recovery Of The Benefits Arrogated By The Broker Themselves From The Brokers' Use Of Its Customers Funds And Balances Even Though There Are No Federal Remedies 20

D. The Writ Should Be Granted In Order To Apply Basic Principles Of Trust Law Uniformly To An Industry That Has Succeeded In Achieving Immunity From Its Fiduciary Obligations As To "Free Credit Balances" 22

CONCLUSION 23

APPENDIX

Appendix A
Declarations of Respondents as to Number of Accounts Held by Customers Nationally as Filed Originally in the Superior Court of the State of Arizona, Solomon, et al. v. Kemper Securities, et al., No. CV 93-11503 ..... A1

Appendix B
"Free Credit Balances" as Defined in 17 CFR §240.153c3-3(a)(8) A25

Appendix C
Order of Court of Appeals of New York Entered September 11, 1997 Denying Appeal by Right Based Upon Constitutional Issues .. A26

Appendix D
New York Court of Appeals Final Order and Judgment Denying Motion for Leave to Appeal Entered December 17, 1997 ..... A31

Appendix E
Opinion and Judgment of New York Supreme Court (First Department, Appellate Division) dated April 22, 1997 Reversing Supreme Court A34

Appendix F
Opinion and Judgment of New York Supreme Court dated May 7, 1996, re: Amended Complaint A38

Appendix G
First Amended Complaint dated July 10, 1995 . . . . . A50

Appendix H
United States Constitution, Art. VI, Cl. 2, Supremacy Clause A84

Appendix I
Opinion and Judgment of Supreme Court of New York (Appellate Division, First Department) dated April 22, 1997. (Actual Opinion) A85

Appendix J
CPLR 5601()b)(1), New York Civil Practice Code, Governing Appeals by Right A91

Appendix K
Motion of Plaintiffs-Appellants for Leave to Appeal to New York Court of Appeals A92

Appendix L
Original Braunstein Complaint, filed April 25, 1994 . . . . . A137

Appendix M
Order and Opinion of Judge Schackman (New York Supreme Court) dated June 7, 1995, re: Original Complaint A154

Appendix N
Greenwald v. Shearson Lehman Bros., Inc., dated November 4, 1993, New York Law Journal (New York Supreme Court) A175

Appendix O
11 N.Y. Jur. 2d Broker ¶45, New York Jurisprudence A177

Appendix P
Notice of Appeal to Court of Appeals of New York, dated May 27, 1997 . . . . . A178

Appendix Q
Letter from Clerk, Court of Appeals to Petitioners' Counsel, dated 5/30/97 . . . . . A181

Appendix R
Letter from Petitioners' Counsel to Clerk, Court of Appeals, dated 6/10/97 . . . . . A183

Appendix S
Notice to Broker-Dealers Concerning Interest-Bearing Free Credit Balances, Exchange Act Release No. 34-18262, [1981 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶25, 134B (Nov. 17, 1981) A189

Appendix T
In re Newman (Ann), SEC Ruling [1970-71 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 78,177 (Div. of Trading and Markets May 6, 1971) A192

Appendix U
Sections 16 and 18 of the 1933 Securities Act, 15 U.S.C. §77p and r (1993) A196

Appendix V
Proposal to Adopt Rules 15c3-3 and 15c3-4 Under the Securities Exchange Act of 1934 and to Amend Rules 8c-1 and 15c2-1 Under That Act, Exchange Release No. 34-9388 (Nov. 8, 1971) A198

Appendix W
[Left Blank Intentionally] A206

Appendix X
Rule 436 of New York Stock Exchange, 2 NYSE Guide ¶ 2436 (1996) A207

Appendix Y
Merrill Lynch Broker-Dealer Report to SEC, (BD Report), Showing Over Seven Billion Dollars of Free Credit Balances as of March 26, 1993 . . . . . A208

Appendix Z
Broker-Dealer (B-D) Report Form to SEC . . A210

Appendix AA
Rule 421 of New York Stock Exchange A212

Appendix BB
Quote in Memorandum Opposing Class Certification A214

Appendix CC
SEC, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963) A217

Appendix DD
Restatement (Second) of Trusts, P.I.R. § 203 . . . . . A240

Appendix EE
Restatement (Third) of Trusts, P.I.R. § 213 (1990) A242

Appendix FF
CPLR §5602, New York Code of Civil Practice, Governing Permissive Appeals . . . A244

Appendix GG
Exchange Act–Law Text A245

TABLE OF AUTHORITIES

Page

Federal Constitutional Provisions, Statutes And Regulations

Supremacy Clause of the United States Constitution, Art. VI, cl. 2 . . . . . 2, 3, 12, 20, 21

Section 28(a) of the Securities Exchange Act of 1934, ~~Securities Exchange Act~~, 15 USC §78~~e [c] [3]~~ 3, 7, 8, 9, 10, 11, 21
→ bb [a]

Section 16 of the 1933 Securities Act, 15 U.S.C. § 77p (1993) 9

Section 18 of the 1933 Securities Act, 15 U.S.C. § 77r (1993) 9

Notice to Broker-Dealers Concerning Interest-Bearing Free Credit Balances, Exchange Act Release No. 34-18262 [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 25,134B at 18,327 (Nov. 17, 1981) ("SEC Ret. No. 34-18262") 8, 9

17 CFR §240.15c3-3, SEC Rule 15c3-3 . . . . . 3, 12, 13, 22

SEC, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963) 10, 14

In re Newman (Ann), SEC Ruling, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,177 at 80,545 (Div. of Trading and Markets May 6, 1971) 9

Proposal to Adopt Rules 15c3-3 and 15c3-4
Under the Securities Exchange Act of 1934
and to Amend Rules 8c-1 and 15c2-1 Under that Act,
Exchange Act Release No. 34-9388, 1971 SEC
LEXIS 231 at * 6 (Nov. 8, 1971)
("SEC Rel. No. 34-9388") 11, 13

New York State Authorities, Regulations And Texts

NYSE Rule 436, 2 NYSE Guide ¶ 2436 (1996) 17

CPLR 5601(b)(1), New York Practice Code
(Constitutional Appeals) 3, 7

CPLR 5602(a)(i), New York Practice Code
(Premissive Appeals) 7

11 N.Y. Jur. 2d Brokers ¶ 45 at 392-93 (1981),
New York Jurisprudence 5

Table Of Federal And State Case Authorities

United States Supreme Court Cases

Building & Const. Trade Council v.
Associated Builders,
507 U.S. 218, 113 S. Ct. 1190 (1993) 13

California v. ARC Am. Corp.,
490 U.S. 93, 109 S.Ct. 1661(1989) 13

California v. F.E.R.C.,
495 U.S. 490, 110 S.Ct. 2024 (1990) 10

California Fed. Sav. & Loan Ass'n v. Guerra,
479 U.S. 272, 107 S.Ct. 683 (1987) 12

Capital Cities Cable v. Crisp,
467 U.S. 691, 104 S.Ct. 2694 (1984) 12

Cipollone v. Liggett Group, Inc.,
505 U.S. 504, 112 S. Ct. 2608 (1992) 13, 15

Conway v. Icahn & Co.,
16 F.3d 504, 509 (2d Cir. 1994) 6

CSX Transp., Inc. v. Easterwood,
507 U.S. 658, 113 S. Ct. 1732 (1993) 13, 15

English v. General Elec. Co.,
496 U.S. 72, 110 S.Ct. 2270 (1990) 12, 15

Freightliner Corporation, et al. v. Ben
Myrick et ux, et al.,
514 U.S. 280, 115 S.Ct. 1483 (1995) 13

Gibbons v. Ogden,
22 US [9 Wheat] 1, 6 L.Ed. 23 (1824) 3

Guice v. Charles Schwab & Co.,
89 N.Y.2d 31, cert denied, 117
S.Ct. 1250, 137 L.Ed.2d 331 (1997) 16

Leroy v. Great Western United Corp.,
443 U.S. 173, 99 S.Ct. 2710 (1979) 10, 21

Maryland v. Louisiana,
451 U.S. 725, 101 S.Ct. 2114 (1981) 13

Medtronic v. Lohr, et al.,
116 S.Ct. 2240, 135 L.Ed.2d 700 (1996) 13

R.J. Reynolds Tobacco Co. v. Durham Co.,
479 U.S. 130, 107 S.Ct. 499 (1986) 12

Rice v. Santa Fe Elevator Corp.,
331 U.S. 218, 230 (1947) 13

Schneidewind v. ANR Pipeline Co.,
485 U.S. 293, 108 S.Ct. 1145 (1988) 12

Silkwood v. Kerr McGee Corp.,
464 U.S. 238, 104 S.Ct. 615 (1984) 15

United States v. Mitchell,
463 U.S. 206 at 225, 103 S.Ct. 2972 23

Circuit And District Court Decisions

Horst v. W.T. Cabe & Co.,
[197-78 Transfer Binder] Fed. Sec. L. Rep.
(CCH) ¶96,213 (S.D.N.Y. October 31, 1977) 8

State Cases

Estate of Braunstein, et al. v. Merrill Lynch,
Pierce, Fenner & Smith, Inc.,
657 N.Y.S.2d 12 (S.Ct., A.D. 1st Dept.
1997) 3, 7

Gilman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,
101 Misc. 2d 655, 421 N.Y.S.2d 794
(S. Ct. N.Y. Co. 1979) and Id.,
93 Misc. 2d 941.
404 N.Y.S.2d 258 (Sup. Ct. N.Y. Co. 1978) ... 5, 8

Greenwald v. Shearson Lehman Bros., Inc.,
N.Y.L.J. Nov. 4, 1993, at 22
(Sup. Ct. N.Y. Co.) 5

Guice v. Charles Schwab & Co.,
89 N.Y.2d 31, cert denied, 117
S.Ct. 1250, 137 L.Ed.2d 331 (1997) 16

People v. Mercer Hicks Corp.,
4 Misc. 2d 55, 155 N.Y.S.2d 740
(Sup. Ct. N.Y. Co. 1956),
aff'd, 3 A.D.2d 708, 160 N.Y.S.2d 806
(1st Dep't 1957) 6

OPINIONS BELOW

The order and opinion of the New York Supreme Court, dated June 7, 1995, and dismissing the Original Complaint (App. M at A154-174) is unreported. The order and opinion of the New York Supreme Court, dated May 7, 1996 (filed May 10, 1996) sustaining the Amended Complaint is unreported (App. F at A38-49). The opinion and order of the New York Supreme Court, Appellate Division, dated April 22, 1997 (reported decision reprinted in full at App. E at A34), which reverses the New York Supreme Court's order sustaining the Amended Complaint, is reported at 657 N.Y.S.2d 12 (S.Ct., A.D. 1st Dept. 1997). The actual opinion is also found at App. I at A85-90. The decisions and orders of the Court of Appeals of New York, dated September 11, 1997 and December 17, 1997 (App. C at A26-30 and App. D at A31-33), both of which denied appeals of the New York Supreme Court, Appellate Division Order affirming the dismissal of the First Amended Complaint of April 22, 1997, are unreported.

JURISDICTION

The orders and judgments of the Court of Appeals of the State of New York, from which this review is sought, were entered respectively on September 11, 1997 denying petitioners appeal as of right upon constitutional grounds and on December 17, 1997 denying the petitioners Motion for Leave to Appeal. (App. C at A26 and App. D at A31)

The statutory bases for review by certiorari of a final judgment rendered by the highest court of the State of New York (its Court of Appeals) is being sought hereunder 28 U.S.C. §§1257, 2101, 2104 and 2106. This jurisdiction is further elaborated in the Rules of the Supreme Court, Part III, Rules 10(b) and (c), 12, 13 and 14.

STATEMENT OF THE CASE

Description Of Proceedings Below

The New York Court of Appeals Final Order of December 17, 1997 (App. D at A31-33) affirmed an order of the Supreme Court of New York (Appellate Division, First Department) (App. E at A34-37 and App. I at A85-90) which dismissed the petitioners Amended Complaint. These orders held that the subject claims according to this Courts prior rulings on the issue of federal preemption were federally preempted, thereby leaving the petitioners as well as millions of entities similarly situated without any form of relief - either state or federal - for the recovery of profits and gains generated by the very broker-dealers (respondents) upon whom their customers such as petitioners relied and trusted. The Supreme Court of New York by opinion dated May 7, 1996 (App. F at A38-49), had previously found that the Amended Complaint (App. G at A50-83) properly pled Breach of Fiduciary Duty and Unjust Enrichment claims against respondents and, additionally, rejected respondents' preemption arguments.

This portion of the Supreme Court of New York's holding stands undisturbed in the opinion of the Supreme Court, Appellate Division, First Department, dated April 22, 1997 (App. E at A34-37 and App. I at A85-90) as those issues were never addressed by the New York Court of Appeals or the Supreme Court (First Department) on appeal; however, the First Department in its April 22, 1997 Opinion reversed and dismissed on the issue of federal preemption only, holding that it would be a violation of the United States Constitution, Art. VI, Cl. 2 (App. H at A84), to permit state claims to go forward (App. E at A34-37 and App. I at A85-90), opinion reported at 657 N.Y.S.2d 12 (S.Ct., A.D. 1st Dept. 1997) as it held squarely at 657 N.Y.S. 2d 13, while incorrectly focusing on the

permissive use of free credit balances (an issue that was never contested by petitioners) rather than the fruits of such usage (App. F at A43-46; App. M at A154-155; see infra, pp. 3 to 6) that:

> Under the Supremacy Clause of the United States Constitution (art VI, cl 2), plaintiffs' claims are preempted by federal law (see, Gibbons v. Ogden, 22 US [9 Wheat] 1, 210-211, 6 L.Ed. 23 (1924)), which provides that the SEC shall prescribe rules and regulations "to provide safeguards with respect to financial responsibility and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers' securities and the carrying and use of customers' deposits or credit balances" (Securities Exchange Act, 15 USC §78o [c] [3], Federal law expressly permits broker/dealers to use free credit balances in connection with such customer-related activities as financing margin purchases, short sales and failed deliveries (17 CFR §240.15c3-3a). Braunstein, 657 N.Y.S.2d at 13. (App. E at A36-37; App. I at A89).

Subsequently on September 11, 1997, and even though the First Department had reversed because of the aforementioned perceived constitutional violation, thereby permitting an appeal by right under New York Appellate Rules, CPLR 5601(b)(1) (App. J at A91), the New York Court of Appeals dismissed the petitioners appeal as of right on constitutional grounds because - in that court's view - there was no constitutional issue (App. C at A29). Petitioners then sought permissive Leave to Appeal on all issues (App. K at A92) and this was also denied finally without opinion on December 17, 1997 (App. D at A31-

32). Now Petitioners timely seek a Writ of Certiorari to correct the egregious misconception by the Court of Appeals of New York State of this Court's preemption decisions as well as its misreading of the federal legislative objectives of existing rules relating to "free credit balances" which caused the Court of Appeals to equate "permissive use" of free credit balances for certain purposes to misuse for others. The absence of any SEC (Securities Exchange Commission) rules and regulations or Congressional pronouncements allocating the benefits derived from the use of "free credit balances" and the clear objectives of the body of regulations extant on this issue are argued more fully at pp. 13 - 16, infra.

As petitioners were all Arizona residents, the case was originally filed in state court in Arizona on July 12, 1993. The case was styled as Solomon, et al. v. Kemper Securities, et al., No. CV 93-11503. The case then and now - in substance - complained that the respondents had engaged in a national pattern of conduct and practice that intentionally delayed payment of benefits rightfully belonging to their customers' (petitioners) in order to benefit themselves through the free and unfettered use of customer funds ("free credit balances") as working capital. On September 30, 1993, respondents moved to dismiss or stay the Arizona case on forum non conveniens grounds, arguing that New York was a more appropriate jurisdiction as it was the financial center of the world and the national clearing point for the transactions which are the subject of the instant litigation. On November 1, 1993, the respondents motion to stay was granted by the Arizona Court. On April 25, 1994, petitioners filed the subject suit seeking damages and injunctive relief in New York state court (App. L at A137-153). Respondents filed a motion to dismiss on various grounds, including Federal preemption and for failure to state claims of unjust enrichment and breach of fiduciary duty.

On June 7, 1995, Justice Schackman of the New York Supreme Court rejected the respondents arguments regarding Federal preemption and other Constitutional issues, but granted the motion to dismiss for failure to state claims (App. M at A154-174). On July 10, 1995, petitioners filed an Amended Complaint (App. G at A50-83), and again the respondents filed a motion to dismiss on all grounds including preemption. On May 7, 1996, Justice Schackman sustained all claims, rejected out of hand the preemption argument and denied respondents' motion to dismiss on all grounds (App. F at A38-49) (unreported) while specifically finding that broker-dealers owed a fiduciary duty to their customers in regard to free credit balances:

> [T]he relationship between a stockholder and its customer in connection with the broker's handling of the customer's funds, is that of principal and agent and, thus, is fiduciary in nature. (emphasis added) (unreported) (Full Opinion at App. F at A41-42.)

This finding was in consonance with New York law. See Gilman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 93 Misc. 2d 941, 944, 494 N.Y.S.2d 258, 262 (S.Ct. N.Y. Co. 1978) ("[T]he relationship between a stockbroker and his customer is one of principal and agent [cite omitted]. The broker, once he has received his customer's funds, is a fiduciary with respect to those funds."); Greenwald v. Shearson Lehman Bros., Inc., N.Y.L.J. Nov. 4, 1993, at 22 (Sup. Ct. N.Y. Co.) (App. N at A175) ("whenever the broker is acting as the agent of the customer, for example, in executing a customer's order, *or handling customer funds*, the customer has the right to assume and rely on the fact that the broker is acting for his or her benefit at all times during the relationship") (emphasis added); and 11 N.Y. Jur. 2d Brokers ¶ 45 at 392-93 (1981)

(App. O at A177) ("The relationship between a stockbroker and his customer is that of principal and agent and is fiduciary in nature, *especially where the customer deposits money with the broker for the purchase of securities or deposits securities with the broker for sale or exchange.*") (emphasis added).[3] This decision also upheld petitioners claim for unjust enrichment saying:

> The amended complaint alleges that very few of the defendants' customers sign account agreements with the defendants for cash or non-margin securities accounts; that of those customers who do sign such written account agreements, very few, if any are given copies of the agreements after they have signed and returned them to the defendants. It is further alleged that none of the plaintiffs have entered into a contract with any of the defendants which provides that the defendants may reap an economic benefit from the customer's free credit balances without an accounting to the customer . . .. In accordance with the prior Decision, these claims are sufficient to state a claim for unjust enrichment. (App. F at A47-48)

On September 30, 1996, respondents appealed from that Order. On April 22, 1997, the Appellate Division, First Department reversed the Supreme Court of New York and

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[3] Accord People v. Mercer Hicks Corp., 4 Misc. 2d 55, 58, 155 N.Y.S.2d 740, 744 (Sup. Ct. N.Y. Co. 1956), aff'd, 3 A.D.2d 708, 160 N.Y.S.2d 806 (1st Dep't 1957); Conway v. Icahn & Co., 16 F.3d 504, 509 (2d Cir. 1994).

dismissed petitioners' claims, on Constitutional and Preemption grounds only. Braunstein, 657 N.Y.S.2d at 12. (App. E at A34).

Due to the cited language of the Appellate Division's Order, petitioners believed that they had an appeal as of right under CPLR §5601(b)(1) of the Practice Code of New York (App. J at A91) and requested that the Court of Appeals grant an appeal by right upon the Constitutional issues on which reversal was ordered, such reversal involving at its core the Supremacy Clause. Braunstein, 657 N.Y.S. 2d at 13 (App. E at A36-37). This request was done by an exchange of letters with the Court of Appeals of New York according to the practice of that Court. (App. P at A178-180; App. Q at A181-182, App. R at A183-188) In spite of the cited language and holding, the Court of Appeals on September 11, 1997 (entered in the Supreme Court on September 18, 1997) held that there was no constitutional question and, therefore, no appeal or right. (App. C at A26-30) Petitioners then sought permissive leave to appeal under the Civil Practice Code of New York, CPLR §5602 (App. FF at A244) and were denied same on December 17, 1997. (App. D at A31-33 and App. K at A92-136) It is that order upon which this motion for writ of certiorari seeks review.

REASONS FOR GRANTING THE WRIT

A. The Writ Should Be Granted In Order To Correct The Palpable Conflicts Between The Legislative Purposes Of Section 28(a) (The Savings Clause) Of The 1934 Securities Exchange Act, 15 U.S.C. §78bb[a] Which Preserves All Common Law Claims Not Federally Preempted And The Standards for

Preemption as Applied By The Court of Appeals of the State of New York

1. Neither Congress Nor The SEC Preempted Common Law Claims of Breach of Fiduciary Duty and Unjust Enrichment Against Broker/Dealers (Respondents) or Claims Regarding Free Credit Balances By Their Customers (Petitioners); Section 28(a) Of The Securities Exchange Act Of 1934, 15 U.S.C. §78bb(a) (1993) Expressly Preserves Common Law Claims

New York courts have consistently treated claims involving free credit balances as state, not federal, claims. See, e.g., Horst v. W.T. Cabe & Co., [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,213 (S.D.N.Y. October 31 1977) (claim that broker refused to surrender to customer that customer's free credit balances); Gilman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 101 Misc. 2d 655, 421 N.Y.S.2d 794 (S. Ct. N.Y. Co. 1979) and Id., 93 Misc. 2d 941, 404 N.Y.S.2d 258 (Sup. Ct. N.Y. Co. 1978) (certified class of customers entitled to a return of the profits realized through broker's practice of withholding free credit balances by extending artificially the use thereof). However, should the Court of Appeals decision stand, there will be no remedies for damages based upon such claims.

The SEC has expressly stated -- on numerous occasions -- that payment for the use of free credit balances is not a matter of federal regulatory concern. Notice to Broker-Dealers Concerning Interest-Bearing Free Credit Balances, Exchange Act Release No. 34-18262 [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 25,134B at 18,327 (Nov. 17, 1981) ("SEC Ret.

No. 34-18262") (App. S at A190-191); In re Newman (Ann), SEC Ruling, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,177 at 80,545 (Div. of Trading and Markets May 6, 1971) (App. T at A194). The SEC has additionally and emphatically stated that "the payment of interest by broker-dealers on free credit balances that arise as an incidence of customer securities activities is a business matter between a broker-dealer and its customer and normally *will not raise regulatory concerns*." SEC Rel. No. 34-18262, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 25,134B at 18,327 (Nov. 17, 1981) (emphasis added) (App. S at A191). There is no federal regulatory scheme involving free credit balances, nor is there any authority for the Court of Appeals of New York State to emasculate claims that have long been established state claims by New York courts. There have been some attempts by a few states to control the usage of free credit balances. (App. CC at A236). The respondents have honored these standards presumably and should be required to honor other rights asserted under state common law.

Section 28(a) of the Securities Exchange Act of 1934 [15 USC §78bb(a) (1993)] expressly states that "the rights and remedies provided by this title shall be *in addition* to any and all other rights and remedies that may exist at law or in equity," and further provides that state Securities Commissions may have jurisdiction over "any person insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder." 15 U.S.C. §78bb(a) (1993) (emphasis added).[4] It

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[4] Sections 16 and 18 of the 1933 Securities Act contain similar "savings" clauses, 15 U.S.C. § 77p and 77r (1993), (App. U at A196-197). This Section provides further strength to the argument that preservation of common law claims was meant to complement any regulatory scheme governing broker-dealers.

is the former proviso regarding private, state law claims, rather than the effect of §28 upon state securities commissions or blue sky laws or any stated "DUTY" upon any federal court or agency as mandated by §28, with which this matter is concerned. See Leroy v. Great Western United Corp., 443 U.S. 173, 179-180, f.n. 10. Congress and the SEC expressly recognized and allowed state authority to remain with respect to the issues raised by these claims.[5] Federal courts have been unwavering in their recognition of the viability of state common law claims in securities cases.

The express language found in the pertinent rules and regulations casts aside all doubt that it did intend to preempt all aspects of the use of free credit balances. Just as courts may not find state measures preempted in the absence of clear evidence of Congressional and SEC intent, so must courts give full effect to evidence that Congress and the SEC considered and sought to preserve the states' coordinating regulatory role in the federal scheme. California v. F.E.R.C., 495 U.S. 490, 107 S.Ct. 683 (1990).

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[5] See, e.g., SEC Rel. No. 34-9388, 1971 SEC LEXIS 231 at * 6 ("It should be emphasized that the reserve provisions of proposed Rule 15c3-3 ... in no way purport to affect or diminish the rights of any customer under existing applicable law in his relationship with his broker-dealer with respect to his funds and securities.")(App. V at A204); SEC, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., Ch. III.D.1.d. (1963) (recognizing "the importance of the rules and regulations *of various state* and federal regulatory agencies as well as those of the exchanges and the NASD in providing rights and protection for customers" in connection with the "nature of agreements between broker/dealers and their customers") (emphasis added). (App. CC at A229)

Importantly, the Securities Exchange Act also has "savings" clauses incorporated in section 28(a) of the Act (15 USC §78bb[a]) (App. GG at A245), which provides that the Exchange Act's rights and remedies are "in addition to any and all other rights and remedies that may exist at law or in equity," and that the Act does not "affect the jurisdiction of [states] over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules or regulations thereunder." The SEC has similarly stated:

> It should be emphasized that the reserve provisions of proposed Rule 15c3... are designed exclusively to provide a means for computing and maintaining required reserves and that they would in no way purport to affect or diminish the rights of any customer under existing applicable law in his relationship with his broker-dealer with respect to his funds and securities.

Proposal to Adopt Rules 15c3-3 and 15c3-4 Under the Securities Exchange Act of 1934 and to Amend Rules 8c-1 and 15c2-1 Under that Act, Exchange Act Release No. 34-9388, 1971 SEC LEXIS 231 at * 6 (Nov. 8, 1971) ("SEC Rel. No. 34-9388") (App. V at A204). The Court of Appeals failed to consider the impact of this express Congressional and agency language authorizing continued state involvement as to whether the savings clauses extend to cover the claims asserted by the petitioners.

2. The Supremacy Clause Does Not Preempt The Subject Claims For an Accounting Based Upon Breach of Fiduciary Duty and Unjust Enrichment

This Court has established the framework for preemption. Under the Supremacy Clause, U.S. Const. art. VI. cl. 2 (App. H at A84) - the only ground given by the First Department for preemption and affirmed by the Court of Appeals - federal law can preempt the application of state common law in only three circumstances. English v. General Elec. Co., 496 U.S. 72, 78-79, 110 S.Ct. 2270 (1990). First, Congress can express in the statute its clear intent to preempt state law and the exact extent to which preemption occurs. Id. Second, preemption can occur, in the absence of explicit statutory preemptive language, when Congress implicitly indicates an intent to "occupy an *entire field* of regulation to the exclusion of state law." Id. (emphasis added). The chief indication of implicit intent to preempt state law is when Congress has legislated so comprehensively that it has left no room for supplementary state legislation which may become an obstacle to the "full purpose and objective of Congress." Capital Cities Cable v. Crisp, 467 U.S. 691, 699, 104 S.Ct. 2694 (1984). See also R.J. Reynolds Tobacco Co. v. Durham Co., 479 U.S. 130, 142, 107 S.Ct. 499 (1986); Schneidewind v. ANR Pipeline Co., 485 U.S. 293, 299, 108 S.Ct. 1145 (1988). Finally, state common law may be preempted if it "actually conflicts" with federal law. English, 496 U.S. at 79. Conflict preemption occurs either when compliance with both the state and federal laws is "physically impossible" or "where it stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." English, 496 U.S. at 79; California Fed. Sav. & Loan Ass'n v. Guerra, 479 U.S. 272, 281, 107 S.Ct. 683 (1987).

This Court has stated that preemption of state law is not favored. English, 496 U.S. at 91; California Fed. Sav. & Loan Ass'n v. Guerra, 479 U.S. at 281. There is a long standing presumption *against* finding federal preemption of state law in areas traditionally regulated by the states. English, 496 U.S. at

79; CSX Transp., Inc. v. Easterwood, 507 U.S. 658, 113 S. Ct. 1732, 1737 (1993); Building & Const. Trade Council v. Associated Builders, 507 U.S. 218, 113 S. Ct. 1190, 1194, 1198 (1993); California v. ARC Am. Corp., 490 U.S. 93, 101, 109 S.Ct. 1661 (1989); Maryland v. Louisiana, 451 U.S. 724, 746, 101 S.Ct. 2114 (1981) (consideration under Supremacy Clause starts with basic assumption that Congress did not intend to displace state law). Thus, preemption will not lie unless it "is the clear and manifest purpose of Congress." Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947). Accord, Cipollone v. Liggett Group, Inc., 505 U.S. 504, 112 S. Ct. 2608, 2618(1992). This preemption has not been rebutted by respondents arguments in the courts below.

This Court has clearly stated that the "... absence of a federal standard cannot implicitly extinguish state common law." Freightliner Corporation, et al. v. Ben Myrick et ux, et al., 514 U.S. 280, 282, 115 S.Ct. 1483, 1485 (1995). Moreover, even an express preemption - not found at bar - cannot become an implied preemption. Freightliner, 15 S. Ct. at 1486. Nor do substantially identical state and federal standards of behavior or performance (which do not exist in the instant matter) preempt state causes of action. Medtronic v. Lohr, et al., 116 S.Ct. 2240, 135 L.Ed.2d 700 (1996).

In summary, petitioners' common law claims do not conflict with federal law as no federal standards exist which "conflict" and there is no purpose or objective of Congress or the SEC which would be frustrated or undermined by permitting state claims and remedies as none exist in regard to "free credit balances."

3. The Mere Existence of Some Federal Regulation Permitting the Use of "Free Credit Balances" Belonging to Customers of

Broker-Dealers By Broker-Dealers Does Not Evidence Intent to Preempt State Regulation of State Law Claims for Redress by Customers of Broker-Dealers For Benefits Improperly Arrogated By Broker-Dealers to Themselves From Such Use As The Federal Regulations That Do Exist In Such Regard Were Enacted Only For Purposes Of Protecting Customer Funds And Securities Through The Establishment Of Rules For Preservation Of Broker "Net Capital Requirements" And Broker Liquidity

The body of rules and regulations relating to free credit balances has as its sole objective the preservation and segregation of customers' assets through the establishment of strict "net capital requirements" and does neither seek to embrace the balances under any securities law provision, not call these balances "securities." The seminal analyses of the background of "free credit balances" is contained in the "Report of Special Study of Securities Markets of the Securities and Exchange Commission" which on its Title page styles the Report as "relating to the adequacy of investor protection in the securities market." (App. CC at A218) The disastrous lessons of the financial depression years brought about in part by the commingling of broker and customer assets was thereby meant to be avoided. This clear and intended purpose of federal activity in this area is not meant to erase the common law rights of petitioners. (App. CC at A220-222 and A227-228) It was so held in the Supreme Court of New York below, but reversed by the Appellate Division and affirmed by the Court of Appeals, without opinion. (App. F at A38-49 and App. M at A154-174).

It has long been held that the existence of some federal regulation or statute on a given subject -- no matter how

comprehensive -- alone is insufficient to justify preemption of state law. English v. General Elec. Co., 496 U.S. at 87 ("Undoubtedly, every subject that merits congressional legislation is by definition, a subject of national concern. That cannot mean, however, that every federal statute ousts all related stated law...."). Accord, Cipollone v. Liggett Group, Inc., 112 S. Ct. 2608, 2618 (1992) ("That Congress requires a particular warning label does not automatically preempt a regulatory field"; holding that certain common law damages actions are not preempted by Federal Cigarette Labelling and Advertising Act); CSX Transp., Inc. v. Easterwood, 113 S. Ct. at 1739-40 (regulation adopted under Federal Railroad Safety Act, which required states to determine need for, and type of safety devices to be installed at grade crossing did not preempt state common law negligence claim regarding railroad's duty to install traffic control devices at crossings). Even a comprehensive federal statutory scheme does not necessarily preempt state claims - let alone the complete absence of one as at bar. This Court in Silkwood v. Kerr McGee Corp., 464 U.S. 238, 256, 104 S.Ct. 615, 625 (1984) 78 L.Ed.2d 443 (1984) stated at 464 U.S. 256 in regard to the "tension," if any, between state and federal law:

> No doubt there is tension between the conclusion that safety regulation is the exclusive concern of the federal law and the conclusion that a State may nevertheless award damages based on its own law of liability. But as we understand what was done over the years in the legislation concerning nuclear energy, Congress intended to stand by both concepts and to tolerate whatever tension there was between them. Silkwood, 464 U.S. at 256.

The Appellate Division's decision to grant

Respondents' Motion to Dismiss Appellants' Amended Complaint is substantially predicated upon the recent New York Court of Appeal's decision in Guice v. Charles Schwab & Co., 89 N.Y.2d 31, cert denied, 117 S.Ct. 1250, 137 L.Ed.2d 331 (1997) (App. W at A206). Relying erroneously on that recent decision of the Court of Appeals of New York involving "order flow payments", the Appellate Division reversed the trial court and held that this action was similarly preempted by the 1970 amendments to the Securities Exchange Act and regulations promulgated thereunder. The Appellate Division and the New York Court of Appeals equated the regulation of order flow payments with the non-regulation of the allocation of benefits and profits from the use of "free credit balances." Order flow payment practice involved the broker commission structure, an area in which the SEC has particular expertise and that has always been regulated by the SEC. It is a specific practice which has been monitored and studied by the SEC for many years. The details of that study, and of requirements of fee structures fashioned by the SEC as early as 1977, are contained in the Court of Appeal's opinion in Guice under the caption *Federal Regulation of Order Flow Payments.* 89 N.Y.2d at 41-43. There has been no monitoring or fashioning of requirements with respect to the broker-dealer manipulation and misuse of free credit balances.[6]

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[6] Respondents have made specious arguments that full disclosure by them have cured any wrong complained of herein. There is no disclosure by respondents of the amount of free credit balances held in any customers account, nor of the huge benefits obtained quietly by the brokers from the use thereof. It should be additionally made clear that petitioners are not seeking interest on free credit balances as compensation for the use of their funds as therein possibly lies a conflict with federal prohibition of deposits by customers being made for "interest" only, as would be the case with banking practices. Such interest is prohibited by [f.n. continued p. 17]

B. The Writ Should Be Granted Because The Importance Of The Federal Question At Bar Is Articulated By The Finding In The New York Supreme Court That Securities Brokers (Respondents) Are Fiduciaries In Their Relation To Their Customers (Petitioners) Thereby Further Warranting Review By This Court As Respondents' Actions And Business Policies As Fiduciaries Affect Of Millions Of People And Billions Of Dollars

Petitioners here complain of a national industry-wide practice in the securities industry that as a fiduciary to its customers has literally made improper profits from millions, if not billions, of dollars and tens of millions of securities customers (App. G at A55-56, 60). Were this practice only inflicted on the unfortunate few, then the overwhelming importance of the federal question might not exist. In this case, however, virtually every account pervading the 30,000,000

Rule 436 of the Rules of the New York Stock Exchange (App. X at A207). This case has nothing to do with such "deposits" for interest only, [f.n. continued p. 17] even though interest imputed to free credit balances may be one measurement of the partial extent of the benefits achieved by the complained of broker practice and the resulting damages to their customers. Interestingly, since the inception of this litigation at least two respondents have begun the practice of paying a portion of the benefits on free credit balances to their customers in the form of nominal interest thereon, suggesting thereby that all of the respondents could do the same even though they choose not to.

accounts with the respondents has been damaged whenever they have had a free credit balance created as a result of a securities transaction. (App. G at A51-53 and A63-66) Petitioners had such balances in their accounts (App. G at A66-78). Discovery conducted prior to dismissal that one respondent alone, i.e. Merrill Lynch, as reported (on its Broker-Dealer Form (App. Y at A208-209)) had over Seven Billion Dollars ($7,000,000,000) in free credit balances in customers accounts on 3/26/93, all of which monies were being beneficially used by Merrill Lynch with no benefits allocated to its customers, the true beneficiaries and owners of such funds. As early as 1962, NYSE members were reporting between 1-2 Billion Dollars in "free credit balances" (App. CC at A230-234) so the subject practice has been continuous and quantifiable since then at least. The respondents are required to file B-D (Broker-Dealers) Reports with the SEC at specific intervals segregating the amount of free credit balances on hand (App. Z at A210-211). Rule 421 of the New York Stock Exchange requires the same (App. AA at A212-213). These amounts are recognized by the broker-dealers as essential to their working capital needs and their impact upon overnight borrowing from the Federal Reserve System; i.e., the more "free credit balances" at no cost to broker-dealer, the less loans at some cost from the Federal Reserve System are needed and the greater receipt of interest from customers on margin loans. (App. CC at A232-237). It was so alleged. (App. G at A79)

These funds held by the broker as fiduciary for others and arise when a customer sells a security or receives a dividend or an interest payment or otherwise receives or deposits funds in his or her account. (App. CC at A230). When, as in most cases, the customer has a money market account, the brokers unnecessarily delay sweeping customer funds into the interest bearing account even though the brokers have the capability to program its computers so that these funds

are not kept and used by them overnight. When a customer transfers accounts from one broker-dealer to another, the broker-dealer unnecessarily delays the transfer; delays in the receipt of dividends and interest and their subsequent credit or transmittals in kind to customers is a common and uniform practice. There is an all pervasive practice of sweeping funds out of a customer's account on the exact settlement date of a "purchase" transaction on the very date the purchase price is due the broker, but waiting overnight to sweep funds to the customer one day after the settlement date on the "sell" transaction thereby permitting broker usage and benefits overnight. All of the above were clearly alleged by petitioners in their Original and Amended Complaint (App. G at A52-53; App. L at A142-143). In short, they engage in a host of schemes to create and maximize a "float" on the customers' money which - during the interval between the respondents use of the funds and transmittal to their customers in one form or another - creates huge benefits for the respondents. The broker creates a situation in which it borrows less from working capital sources, thereby saving on interest payments and further using such funds to create revenue by lending them at interest via margin accounts to the very customers to whom these funds belong. In a word, "free credit balances" become "free working capital." These are practices to which the respondents have admitted. This practice creates a major source of income for brokers (App. CC at A232-234). The respondents proudly stated in their Memorandum in Opposition to Class Certification that:

> "[T]he long standing industry practice was not to pay benefits earned on free credit balances to the customer." (App. BB at A216) (Declaration of Respondents In Memorandum in Opposition to Petitioners' Class Certification Memo)

Most free credit balances are no longer held by a broker-dealer "as a matter of [customer] choice and convenience" as they were twenty or thirty years ago when securities transactions were not computerized. Now, however, free credit balances are calculated by the brokers' computer systems instantaneously and on a daily, if not hourly, basis by the press of a button. Anyone can phone their broker and obtain an immediate reading of their free credit balance (App. G at A63) There can be no motive in this age of electronic communication and transmission of funds for unnecessarily creating[7] free credit balances other than to maximize the "float," generated an unending source of free working capital and unjustly enrich themselves in direct violation of their duties as fiduciaries. (App. G at A64; App. CC at A225-228). Yet, based on the New York State Court of Appeals ruling, petitioners are without a state or federal remedy as the New York Court of Appeals did not distinguish between the mere use of free credit balances and the profits or benefits from such use.

C. The Writ Should Be Granted Due To The Importance Of The Federal Question Arising When The Court Of Appeals Of The State Of New York In Its Affirmance Of A Lower Court Opinion Found That The Supremacy Clause Of The United States

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[7] Unnecessary creation of free credit balances occurs, for example, when broker-dealers program their computers to delay overnight or more sweeps of received funds into the customer's money market account even though the broker has access to those funds the day the funds are received by the broker, one day before the customer does (App. G at A62-64). The benefits to the brokers are gigantic.

Constitution, Article VI, Clause 2 Federally Preempted All Common Law Rights Of Redress For Breach Of Fiduciary Duty And Unjust Enrichment By The Customer Of A Securities Broker Against The Securities Broker For Recovery Of The Benefits Arrogated By The Broker From The Broker's Use Of Its Customers Funds And Balances Even Though There Are No Federal Remedies

The states have played an active role in the control and enforcement of securities laws and claims. Section 28(a) leaves the several states authority in these regards and this Court has recognized such authority as being protected rather than limited. Leroy v. Great Western United Corp., 443 U.S. 173, 182, f.n. 13, supra. The benefits entitlement from the use of funds and balances belonging to brokers' customers - whether to the broker or customer - has never been regulated by any federal statute or rule nor do such "balances" satisfy any definition of "securities" under federal law; respondents have successfully argued to date, however, that these "balances" are preempted by the federal "securities" law and regulations and that the permission to use customers funds and balances held by them as fiduciaries to finance customer related activities such as short sales and failed deliveries pursuant to the terms of SEC Rule 15c 3-3 (App. B at A25) carries with it the right to acquire the full benefits from gains resulting from those uses as well as general working capital applications for telephone expenses, salaries, rent, etc. (App. CC at A230-234) It is the latter part

of this equation upon which petitioners seek review.[8]

D. The Writ Should Be Granted In Order To Apply Basic Principles Of Trust Law Uniformly To An Industry That Has Succeeded In Achieving Immunity From Its Fiduciary Obligations As To "Free Credit Balances"

The continued impunity with which broker-dealers use immense amounts of their beneficiaries funds for their own purposes comes down to the simple proposition above. If this Court gives its imprimatur to the "free credit balance" practice, the continuation of such practice will certainly stand for the proposition that the trustee owes no duty and is not accountable to its beneficiaries as long as that trustee is a securities broker.

The universal belief of the courts, the legal writers and the public is that the beneficiary of a trust has an absolute right to any profits or benefits the trustee makes from its principals' assets - and that litigation over that issue would inevitably favor the beneficiary. This concept has remarkably escaped the securities industry treatment of "free credit balances."

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[8] Free Credit Balances not used to finance customer related activities are required to be segregated in a reserve bank account in order to assure the protection of the integrity of customers' funds and securities [Rule 15c3-3(a)] (App. B at A25). Nevertheless, the benefits from such reserves which are applied to any and all of respondents' business expenses are arrogated to the brokers, not the customers, as brokers make wide usage of free credit balances as their own assets to lessen federal reserve or commercial bank borrowings and for interest bearing margin loans to their customers. (App. CC at A236-238)

The Restatement (Second) of Trusts, §203 (1959) (App. DD at A266) states clearly:

> ". . . (a) trustee is accountable for any profit made by him arising out of the administration of the trust, regardless of whether he entered into the transaction with the intent of making a profit for himself or not, and regardless of the fact that he commits no breach of that trust in so doing."

This is basic horn-book law; however, it has not yet been applied to the securities industry. This Court in United States v. Mitchell, 463 U.S. 206 at 225, 103 S.Ct. 2972 recognized the unassailable principle that "... a trustee is accountable in damages for breaches of trust. (Citations omitted)." There can be no other concept. The Restatement of the Law of Trusts (3d) (1990) in comment on this ancient precept says "[I]t is fundamental that the trustee is accountable for all profits arising out of the administration of the trust, whether or not they result from breach of trust...." P.I.R. §213 (1990 Main Volume) (App. EE, A242).

CONCLUSION

The New York Court of Appeals order (App. D at A31-33) of December 17, 1997 affirming the New York Supreme Court's order of April 22, 1997 (App. I at A85-90) is erroneous and should be reviewed. The New York Supreme Court, First Department (Appellate Division) in its April 22, 1997 order has decided and the New York Court of Appeals in its December 17, 1997 order has affirmed, erroneously, that petitioners' case is preempted by federal law; further, the Court of Appeals rejection of the petitioners appeal by right to that

court followed by the denial of permissive appeal even though constitutional issues permeate this case, only highlights the necessity of review.

This case presents important questions of federal law, especially for the millions of small, individual investors who have been affected by the securities industries treatment of "free credit balances" and who will be affected by the outcome of this litigation for all time to come. Petitioners ask this Court for an opportunity to fully brief these and all of the issues discussed above. For the foregoing reasons, Petitioners respectfully requests that the within Petition for Certiorari be granted.

Dated: March 9, 1998

Respectfully submitted,

/s/_____

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Counsel for Petitioners

APPENDIX

APPENDIX A

IN THE SUPERIOR COURT OF THE STATE OF ARIZONA IN AND FOR THE COUNTY OF MARICOPA

BURTON SOLOMON, et al.)	
Plaintiffs,	) No. CV 93-11503
	)
v.	) AFFIDAVIT OF DANIEL
	) A. DOLAN,
KEMPER SECURITIES	) REPRESENTATIVE OF
GROUP, INC. and	) MERRILL LYNCH
KEMPER SECURITIES,	) PIERCE FENNER &
INC., et al.,	) SMITH, INC.
Defendants.	)
_____/	
STATE OF NEW YORK	)
	) SS.
COUNTY OF NEW YORK	)

I, Daniel A. Dolan, do hereby depose and say:

1. I am a Vice President and Assistant General Counsel of the Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch"). I am aware of the facts stated herein, from my own personal knowledge or from reviewing business records of Merrill Lynch and making inquiry in various areas of the Firm.

* * *

3. Merrill Lynch has approximately 6.9 million customer accounts of which only 97,622 are located in the State of Arizona.

* * *

DATED this 27 day of September, 1993.

/s/_____
DANIEL A. DOLAN
Vice President and Assistant
General Counsel
Merrill Lynch, Pierce, Fenner &
Smith, Inc.

AFFIDAVITS OF REPRESENTATIVES FROM VARIOUS INVESTMENT FIRMS

IN THE SUPERIOR COURT OF THE STATE OF ARIZONA IN AND FOR THE COUNTY OF MARICOPA

BURTON SOLOMON, et al.)	
Plaintiffs,	) No. CV 93-11503
	)
v.	) AFFIDAVIT OF LOREN
	) ROBINSON,
KEMPER SECURITIES	) REPRESENTATIVE OF
GROUP, INC. and	) PRUDENTIAL
KEMPER SECURITIES,	) SECURITIES, INC.
INC., et al.,	)
Defendants.	)
_____/	
STATE OF NEW YORK	)
	) SS.
COUNTY OF NEW YORK	)

I, Loren Robinson, do hereby depose and say:

1. I am a paralegal with Prudential Securities, Inc. ("Prudential Securities"). I am aware of the facts stated herein, from my own personal knowledge or from reviewing business records of Prudential Securities and from making inquiry in various areas of the firm.

* * *

3. Prudential Securities has 276 branches nationwide of which only five are located in the State of

AFFIDAVITS OF REPRESENTATIVES FROM VARIOUS INVESTMENT FIRMS

Arizona. Prudential Securities, Inc. has approximately 2,114,000 accounts nationwide, of which approximately 376,543 are located in the State of Arizona.

DATED this 29th day of September, 1993.

/s/_____
Loren Kelly Robinson
Title: Senior Legal Assistant

AFFIDAVITS OF REPRESENTATIVES FROM VARIOUS INVESTMENT FIRMS

IN THE SUPERIOR COURT OF THE STATE OF ARIZONA IN AND FOR THE COUNTY OF MARICOPA

BURTON SOLOMON, et al.)	
Plaintiffs,	) No. CV 93-11503
	)
v.	) AFFIDAVIT OF
	) REPRESENTATIVE OF
KEMPER SECURITIES	) SMITH BARNEY
GROUP, INC. and	) SHEARSON
KEMPER SECURITIES,	)
INC., et al.,	)
Defendants.	)
_____/	

STATE OF NEW YORK	)
	) SS.
COUNTY OF NEW YORK	)

I, Jerome Clair, do hereby depose and say:

1. I am a Senior Vice President of Smith Barney Shearson, which was created through the recent combination of Smith, Barney, Harris, Upham & Co., Inc. ("Smith Barney") and portions of Shearson Lehman Brothers, Inc. ("Shearson"). My duties include responsibility over the operations of four areas of the firm, including trade processing, reorganization, government clearance and mutual funds. I am aware of the facts stated herein, from my own personal knowledge or from reviewing business records of Smith Barney Shearson.

* * *

3. Smith Barney Shearson has 497 branch offices nationwide, of which 7 are located in the State of Arizona. As of July 30, 1993, Smith Barney had 940,137 accounts nationwide, with only 10,853 located in the State of Arizona.

* * *

DATED this 29th day of September 1993.

/s/_____
Jerome Clair
Senior Vice President

AFFIDAVITS OF REPRESENTATIVES FROM VARIOUS INVESTMENT FIRMS

IN THE SUPERIOR COURT OF THE STATE OF ARIZONA IN AND FOR THE COUNTY OF MARICOPA

BURTON SOLOMON, et al.)	
Plaintiffs,	) No. CV 93-11503
	)
v.	) AFFIDAVIT OF
	) REPRESENTATIVE OF
KEMPER SECURITIES	) SMITH BARNEY
GROUP, INC. and	) SHEARSON
KEMPER SECURITIES,	)
INC., et al.,	)
Defendants.	)
_____/	

STATE OF NEW YORK	)
	) SS.
COUNTY OF NEW YORK	)

I, Joseph Moschella, do hereby depose and say:

1. I am an Executive Vice President of Smith Barney Shearson, which was created through the recent combination of Smith Barney, Harris, Upham & Co., Inc. ("Smith Barney") and portions of Shearson Lehman Brothers Inc. ("Shearson"). My duties include responsibility over the operations of three areas of the Firm, including margin, the processing of dividend and interest payments and the control of securities processing. I am aware of the facts stated herein, from my own personal knowledge or from reviewing business records of Smith

AFFIDAVITS OF REPRESENTATIVES FROM VARIOUS INVESTMENT FIRMS

Barney Shearson.

* * *

3. Smith Barney Shearson has 497 branch offices nationwide, of which 7 are located in the State of Arizona. At the end of July 1993, Shearson had 4,786,134 accounts nationwide, but only 77,844 were located in the State of Arizona.

* * *

DATED this 29th day of September 1993.

/s/_____

JOSEPH MOSCHELLA
Executive Vice President

AFFIDAVITS OF REPRESENTATIVES FROM VARIOUS INVESTMENT FIRMS

IN THE SUPERIOR COURT OF THE STATE OF ARIZONA IN AND FOR THE COUNTY OF MARICOPA

BURTON SOLOMON, et al.)	
Plaintiffs,	) No. CV 93-11503
	)
v.	) AFFIDAVIT OF MICHAEL
	) R. GOLDSTEIN,,
KEMPER SECURITIES	) REPRESENTATIVE OF
GROUP, INC. and	) KEMPER
KEMPER SECURITIES,	) SECURITIES, INC.
INC., et al.,	)
Defendants.	)
_____/	
STATE OF NEW YORK	)
	) SS.
COUNTY OF NEW YORK	)

I, Michael R. Goldstein, do hereby depose and say:

1. I am a Senior Vice President of Kemper Clearing Corp., a subsidiary of Kemper Securities, Inc. ("Kemper Securities"). My duties include responsibility for customer and branch services. I am aware of the facts stated herein, from my own personal knowledge or from reviewing business records of Kemper Securities.

* * *

3. Kemper Securities has 165 branches

nationwide, of which only three are located in the State of Arizona. Kemper Securities has approximately 593,000 accounts nationwide, of which only 19,000 are located in the State of Arizona.

* * *

DATED this 27th day of September, 1993.

/s/_____

MICHAEL R. GOLDSTEIN
Senior Vice President
Kemper Clearing Corp.

AFFIDAVITS OF REPRESENTATIVES FROM VARIOUS INVESTMENT FIRMS

IN THE SUPERIOR COURT OF THE STATE OF ARIZONA IN AND FOR THE COUNTY OF MARICOPA

BURTON SOLOMON, et al.)	
Plaintiffs,	) No. CV 93-11503
	)
v.	) AFFIDAVIT OF JAMES
	) SWEENEY,
KEMPER SECURITIES	) REPRESENTATIVE OF
GROUP, INC. and	) DEAN WITTER
KEMPER SECURITIES,	) REYNOLDS, INC.
INC., et al.,	)
Defendants.	)
_____/	

STATE OF NEW YORK)
) SS.
COUNTY OF NEW YORK)

I, James Sweeney, do hereby depose and say:

1. I am Senior Vice President of Operations Management and Administration of Dean Witter Reynolds, Inc. ("Dean Witter"). I am aware of the facts stated herein, from my own personal knowledge or from reviewing business records of Dean Witter.

* * *

3. Dean Witter has approximately 331 branches nationwide, of which only eight are located in the State of

Arizona. Dean Witter has 3,891,618 accounts nationwide, of which only 73,254 are located in the State of Arizona.

* * *

DATED this 29th day of September, 1993.

/s/_____
JAMES SWEENEY
Senior Vice President

AFFIDAVITS OF REPRESENTATIVES FROM VARIOUS INVESTMENT FIRMS

IN THE SUPERIOR COURT OF THE STATE OF ARIZONA IN AND FOR THE COUNTY OF MARICOPA

BURTON SOLOMON, et al.)	
Plaintiffs,	) No. CV 93-11503
	)
v.	) AFFIDAVIT OF
	) WILLIAM SOCHA,
KEMPER SECURITIES	) REPRESENTATIVE OF
GROUP, INC. and	) ALEX. BROWN & SONS
KEMPER SECURITIES,	) INCORPORATED
INC., et al.,	)
Defendants.	)
_____/	
STATE OF NEW YORK	)
	) SS.
COUNTY OF NEW YORK	)

I, William Socha, do hereby depose and say:

1. I am a Manager of Customer Service of Alex. Brown & Sons Incorporated ("Alex. Brown"). I am aware of the facts stated herein, from my own personal knowledge or from reviewing business records of Alex. Brown.

* * *

3. Alex. Brown has 21 branch offices nationwide, but no branches in the State of Arizona. Alex.

AFFIDAVITS OF REPRESENTATIVES FROM VARIOUS INVESTMENT FIRMS

Brown has approximately 218,000 customer accounts nationwide, but less than 1% are located in the State of Arizona.

* * *

DATED this 29th day of September, 1993.

/s/_____

WILLIAM SOCHA
Manager of Customer Service
Alex. Brown & Sons
Incorporated

AFFIDAVITS OF REPRESENTATIVES FROM VARIOUS INVESTMENT FIRMS

IN THE SUPERIOR COURT OF THE STATE OF ARIZONA IN AND FOR THE COUNTY OF MARICOPA

BURTON SOLOMON, et al.)	
Plaintiffs,	) No. CV 93-11503
	)
v.	) AFFIDAVIT OF LILLIAN
	) TARTAMELLA,
KEMPER SECURITIES	) REPRESENTATIVE OF
GROUP, INC. and	) BEAR STEARNS & CO.
KEMPER SECURITIES,	)
INC., et al.,	)
Defendants.	)
_____/	

STATE OF NEW YORK)
) SS.
COUNTY OF NEW YORK)

I, Lillian Tartamella, do hereby depose and say:

1. I am Vice President of the Compliance Department of Bear Stearns & Co. ("Bear Stearns"). I am aware of the facts stated herein, from my own personal knowledge or from reviewing business records of Bear Stearns.

* * *

3. Bear Stearns has 7 branch offices, but no branch offices in the State of Arizona. Bear Stearns has

approximately 1,000,000 accounts nationwide, but only 4,935 in the State of Arizona.

* * *

DATED this 28th day of September, 1993.

/s/_____

LILLIAN TARTAMELLA
Vice President of the
Compliance Department
Bear Stearns & Co.

AFFIDAVITS OF REPRESENTATIVES FROM VARIOUS INVESTMENT FIRMS

IN THE SUPERIOR COURT OF THE STATE OF ARIZONA IN AND FOR THE COUNTY OF MARICOPA

BURTON SOLOMON, et al.)	
Plaintiffs,	) No. CV 93-11503
	)
v.	) AFFIDAVIT OF HENRY
	) C. ALEXANDER,
KEMPER SECURITIES	) REPRESENTATIVE OF
GROUP, INC. and	) CHARLES SCHWAB &
KEMPER SECURITIES,	) CO., INC.
INC., et al.,	)
Defendants.	)
_____/	
STATE OF NEW YORK	)
	) SS.
COUNTY OF NEW YORK	)

I, Henry C. Alexander, do hereby depose and say:

1. I am Senior Vice President of Operations of Charles Schwab & Co., Inc. ("Schwab"). I am aware of the facts stated herein, from my own personal knowledge or from reviewing business records of Schwab.

* * *

3. Schwab has 15 regional offices, one of which is located in Phoenix, Arizona. Schwab has approximately 2,692,537 accounts nationwide, of which 56,037 are

AFFIDAVITS OF REPRESENTATIVES FROM VARIOUS INVESTMENT FIRMS

2,692,537 accounts nationwide, of which 56,037 are located in Arizona.

* * *

DATED this 30th day of September, 1993.

/s/_____
HENRY C. ALEXANDER
Senior Vice President of
Operations
Charles Schwab & Co., Inc.

AFFIDAVITS OF REPRESENTATIVES FROM VARIOUS INVESTMENT FIRMS

IN THE SUPERIOR COURT OF THE STATE OF ARIZONA IN AND FOR THE COUNTY OF MARICOPA

BURTON SOLOMON, et al.)	
Plaintiffs,	) No. CV 93-11503
	)
v.	) AFFIDAVIT OF PETER C.
	) SALERNO,
KEMPER SECURITIES	) REPRESENTATIVE OF
GROUP, INC. and	) KIDDER, PEABODY & CO
KEMPER SECURITIES,	) INCORPORATED
INC., et al.,	)
Defendants.	)
_____/	

STATE OF NEW YORK	)
	) SS.
COUNTY OF NEW YORK	)

I, Peter C. Salerno, do hereby depose and say:

1. I am a Senior Vice President and Chief of the Litigation Group in the Legal Department of Kidder, Peabody & Co. Incorporated ("Kidder Peabody"). I am aware of the facts stated herein, from my own personal knowledge or from reviewing business records of Kidder, Peabody and from making inquiry in various areas of the firm.

* * *

3. Kidder, Peabody has 43 branch offices nationwide, of which only one is located in the State of Arizona. Kidder, Peabody has approximately 397,000 customer accounts nationwide, of which only approximately 8,000 are located in the State of Arizona.

* * *

DATED this 29th day of September, 1993.

/s/_____

PETER C. SALERNO

AFFIDAVITS OF REPRESENTATIVES FROM VARIOUS INVESTMENT FIRMS

IN THE SUPERIOR COURT OF THE STATE OF ARIZONA IN AND FOR THE COUNTY OF MARICOPA

BURTON SOLOMON, et al.)	
Plaintiffs,	) No. CV 93-11503
	)
v.	) AFFIDAVIT OF
	) ESTILL L. ALVEY,
KEMPER SECURITIES	) REPRESENTATIVE OF
GROUP, INC. and	) PAINEWEBBER,
KEMPER SECURITIES,	) INCORPORATED
INC., et al.,	)
Defendants.	)
_____/	

STATE OF NEW YORK	)
	) SS.
COUNTY OF NEW YORK	)

I, Estill L. Alvey, do hereby depose and say:

1. I am a Senior Vice President of PaineWebber Incorporated ("PaineWebber"), one of the defendants in the above-captioned action. In my present position, I am the Key Financial Contact for financial and certain regulatory affairs for the Firm's Operations, Systems and Administrative Services Division. The facts stated herein are based on my own personal knowledge and on information from the records of PaineWebber gathered by other PaineWebber employees. I subm[illegible]his Affidavit in support of the Motion filed by all the broker/dealer

defendants to dismiss this action on the grounds of form non conveniens.

* * *

3. PaineWebber has 283 branch offices across the United States including five such offices in the State of Arizona. As of June 30, 1993, approximately 1.5% of PaineWebber's accounts were maintained with our Arizona branches.

* * *

DATED this 27th day of September, 1993.

/s/_____

ESTILL L. ALVEY
Senior Vice President
PaineWebber, Incorporated

AFFIDAVITS OF REPRESENTATIVES FROM VARIOUS INVESTMENT FIRMS

IN THE SUPERIOR COURT OF THE STATE OF ARIZONA IN AND FOR THE COUNTY OF MARICOPA

BURTON SOLOMON, et al.)	
Plaintiffs,	) No. CV 93-11503
	)
v.	) AFFIDAVIT OF
	)
KEMPER SECURITIES	) REPRESENTATIVE OF
GROUP, INC. and	) LEHMAN BROTHERS,INC
KEMPER SECURITIES,	)
INC., et al.,	)
Defendants.	)
_____/	

STATE OF NEW YORK	)
	) SS.
COUNTY OF NEW YORK	)

I, Kathryn Bopp Flynn, do hereby depose and say:

1. I am a Senior Vice President of Lehman Brothers, Inc. ("Lehman"). I am aware of the facts stated herein, from my own personal knowledge or from reviewing business records of Lehman.

* * *

3. Lehman has seven branch offices nationwide, none of which are located in the State of Arizona. As of August 27, 1993, Lehman has approximately 103,000

August 27, 1993, Lehman has approximately 103,000 active retail accounts nationwide, but only approximately 840 belong to retail clients with mailing addresses in Arizona.

* * *

DATED this 29th day of September, 1993.

/s/_____
KATHRYN BOPP FLYNN
Title: Senior Vice President

APPENDIX B

CUSTOMER PROTECTION–RESERVES AND CUSTODY OF SECURITIES

Reg. §240.15C3-3. (a) *Definitions*. For the purpose of this rule:

(1) the term "customer" shall mean any person from whom or on whose behalf a broker or dealer has received or acquired or holds funds or securities for the account of that person.

(2) The term "securities carried for the account of a customer" (hereinafter also "customer securities") shall mean:

(i) securities received by or on behalf of a broker or dealer for the account of any customer and securities carried long by a broker or dealer for the account of any customer; and

(ii) securities sold to, or bought for, a customer by a broker or dealer.

* * *

(8) The term "free credit balances" shall mean liabilities of a broker or dealer to customers which are subject to immediate cash payment to customers on demand, whether resulting from sales of securities, dividends, interest, deposits or otherwise, excluding, however, funds in commodity accounts which are segregated in accordance with the Commodity Exchange Act or in a similar manner.

APPENDIX C

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

THE ESTATE OF DAVID J. BRAUNSTEIN and ROSEMARIE BRAUNSTEIN; NEIL WEINER; BURTON SOLOMON; SANDRA MALLIEN; JOANN duPONT; PHILIP KARP; CAROLYN GOODWIN as executrix of the ESTATE OF EDITH CAMPER deceased THOMAS McWHORTER; WILLIAM L. NORTON; RUDOLFO XIMENES; AND ROBERT SAPINZON and RUTH SAPINZON, TRUSTEES SAPINZON FAMILY TRUST, on behalf of themselves and all others similarly situated,

Plaintiffs,

vs.

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED (Merrill), PRUDENTIAL SECURITIES INCORPORATED (Prudential), SMITH BARNEY SHEARSON INC. (Smith Barney), KEMPER SECURITIES GROUP INC. and KEMPER SECURITIES, INC. (Kemper), DEAN WITTER REYNOLDS INC. (Witter), ALEX, BROWN & SONS, INC. (Brown), BEAR, STEARNS SECURITIES CORP. (Bear Stearns), CHARLES SCHWAB & CO., INC. (Schwab), KIDDER PEABODY AND CO. INCORPORATED (Kidder), PAINE WEBBER INCORPORATED (PW), LEHMAN BROTHERS, INC. (Lehman),

Defendants.

Index No. 111667/94
NOTICE OF ENTRY

PLEASE TAKE NOTICE that the within is a true copy of the Decision and Order of the Court of Appeals in this action, duly entered in the office of the Clerk of the Supreme Court, New York County, on or after the 11th day of September 1997.

Dated: New York, New York
September 18, 1997

BROWN & WOOD LLP
One World Trade Center
New York, New York 10048
(212) 839-5300
Attorneys for Defendants

TO:

Matthew S. Dontzin, Esq.
Law Offices of Matthew S. Dontzin
885 Third Avenue, 30th Floor
New York, New York 10022

Frank Lewis, Esq.
Begam, Lewis, Marks & Wolfe
111 West Monroe, Suite 1400
Phoenix, Arizona 85003-1787

Gene Mesh, Esq.
Law Offices of Gene Mesh & Associates

2605 Burnet Avenue
Cincinnati, Ohio 45219
Attorneys for Plaintiffs

STATE OF NEW YORK
COURT OF APPEALS

Stuart M. Cohen
Clerk of the Court

Clerk's Office
Albany, New York 12207-1095

DECISION September 11, 1997

Mo. No. 1049 SSD 63
Estate of David J. Braunstein et al.,
Appellants,
v.
Merrill Lynch, Pierce, Fenner & Smith, Incorporated &c., et al.,
Respondents.

Appeal dismissed without costs, by the Court sua sponte, upon the ground that no substantial constitutional question is directly involved. Judge Bellacosa took no part.

STATE OF NEW YORK,
COURT OF APPEALS

At a session of the Court, held at Court of Appeals Hall in the City of Albany on the eleventh day of September 1997

PRESENT,
HON. JUDITH S. KAYE, *Chief Judge, presiding*

Mo. No. 1049 SSD 63
Estate of David J. Braunstein et al.,
Appellants,
v.
Merrill Lynch, Pierce, Fenner & Smith, Incorporated &c., et al.,
Respondents.

The appellants having filed notice of appeal in the above title and due consideration having been thereupon had, it is

ORDERED, that the appeal be and the same hereby is dismissed without costs, by the Court sua sponte, upon the ground that no substantial constitutional question is directly involved.

Judge Bellacosa took no part.

/s/_____
Stuart M. Cohen
Clerk of the Court

APPENDIX D

STATE OF NEW YORK,
COURT OF APPEALS

At a session of the Court, held at Court of Appeals Hall in the City of Albany on the seventeenth day of December 1997

PRESENT,

HON. JUDITH S. KAYE, *Chief Judge, presiding.*

1-13 Mo. No. 1299
Estate of David J. Braunstein et al.,
Appellants,
v.
Merrill Lynch, Pierce, Fenner & Smith, Incorporated &c., et al.,
Respondents.

A motion for leave to appeal to the Court of Appeals in the above cause having heretofore been made upon the part of the appellants herein and papers having been submitted thereon and due deliberation having been thereupon had, it is

ORDERED, that the said motion be and the same hereby is denied.

/S/_____
Stuart M. Cohen
Clerk of the Court

STATE OF NEW YORK
COURT OF APPEALS

Stuart M. Cohen
Clerk of the Court

Clerk's Office
Albany, New York 12207-1095

DECISION December 17, 1997

1-13 Mo. No. 1299
Estate of David J. Braunstein et al.,

Appellants,

v.

Merrill Lynch, Pierce, Fenner & Smith, Incorporated &c., et al.,

Respondents.

Motion for leave to appeal denied.

Filed December 22, 1997

APPENDIX E

The ESTATE OF David J. BRAUNSTEIN, et al., Plaintiffs-Respondents,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INCORPORATED, etc., et al., Defendants-Appellants.

The Securities Industry Association, Amicus Curiae.

Supreme Court, Appellate Division, First Department.

April 22, 1997.

Class action was brought against broker-dealer, alleging that its use of free credit balances belonging to class members constituted breach of fiduciary duty and violated principles of unjust enrichment under state law. The Supreme Court, New York County, Schackman, J., denied broker-dealer's motion to dismiss. Broker-dealer appealed. The Supreme Court, Appellate Division, held that claim was preempted by federal law.

Reversed.

BROKERS k19

65k19

Claim that broker-dealer's application of customers' free credit balances to its business operations violated fiduciary duties to customers under state law was preempted by federal law, which provided that Securities Exchange Commission

(SEC) would prescribe rules and regulations regarding financial responsibility and related practices of brokers and dealers, including use of customers' credit balances, and permitted broker-dealers to use such balances in connection with such customer-related activities as financing margin purchases, short sales and failed deliveries. U.S.C.A. Const. Art. 6, cl. 2; Securities Exchange Act of 1934, s 15(c)(3), 15 U.S.C.A. s 78o(c)(3); 17 C.F.R. s 240.153c3-3(a)(8).

STATES k18.77
360k18.77
Claim that broker-dealer's application of customers' free credit balances to its business operations violated fiduciary duties to customers under state law was preempted by federal law, which provided that Securities Exchange Commission (SEC) would prescribe rules and regulations regarding financial responsibility and related practices of brokers and dealers, including use of customers' credit balances, and permitted broker-dealers to use such balances in connection with such customer-related activities as financing margin purchases, short sales and failed deliveries. U.S.C.A. Const. Art. 6, cl. 2; Securities Exchange Act of 1934, s 15(c)(3), 15 U.S.C.A. s 78o(c)(3); 17 C.F.R. s240.153c3-3(a)(8).

***12** Frank Lewis, for Plaintiffs-Respondents.

A. Robert Pietrzak, for Defendants-Appellants.

Peter Buscemi, for Amicus Curiae.

Before ELLERIN, J.P., and NARDELLI, RUBIN and MAZZARELLI, JJ.

ESTATE OF BRAUNSTEIN, et al. v.
MERRILL LYNCH, etc., et al. - 657 N.Y.S.2d 12

MEMORANDUM DECISION.

Order of the Supreme Court, New York County (Walter Schackman, JJ.), entered May 10, 1996, which denied defendants' motion to dismiss the amended complaint, unanimously reversed, on the law, without costs, the motion granted and the amended complaint dismissed. The Clerk is directed to enter judgment in favor of the defendants-appellants dismissing the amended complaint. Appeal from the order of the same court and Justice, entered on or about June 7, 1995, which granted defendants' motion to dismiss the complaint, with leave to replead, unanimously dismissed as academic in view of the foregoing.

This class action, predicated on State common-law principles of breach of fiduciary duty and unjust enrichment, seeks an accounting and restitution of any benefit received by defendants from use of "free credit balances" belonging to the class members. "Free credit balances" are defined by regulation of the Securities and exchange Commission (SEC) as "liabilities of a broker or dealer to customers which are subject to immediate cash payment to customers on demand, whether resulting from sales of securities, dividends, interest, *13 deposits or otherwise" (17 C.F.R. s 240.15c3-3[a][8]). Plaintiffs theorize that defendants' application of these funds to their business operations violates defendants' fiduciary duties to their customers.

Under the Supremacy Clause of the United States Constitution (art. VI, cl. 2), plaintiffs' claims are preempted by federal law (see, Gibbons v. Ogden, 22 U.S. [9 Wheat] 1, 210-211, 6 L.Ed. 23), which provides that the SEC shall

prescribe rules and regulations "to provide safeguards with respect to financial responsibility and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers' securities and the carrying and use of customers' deposits or credit balances" (Securities Exchange Act, 15 U.S.C. s 78o[c][3]). Federal law expressly permits broker/dealers to use free credit balances in connection with such customer-related activities as financing margin purchases, short sales and failed deliveries (17 C.F.R. s 240.15c3-3a).

In a similar case in which the plaintiffs complained of the broker/dealers' practice of receiving "order flow payments" (renumeration for routing customers' orders for execution by wholesale dealers), the Court of Appeals held that such common-law claims "are preempted by the 1975 amendments to the Securities Exchange Act and implementing SEC regulations (Guice v. Charles Schwat & Co., 89 N.Y.2d 31, 39, 651 N.Y.S.2d 352, 674 N.E.2d 282, cert. denied -- U.S. ----, 117 S.Ct. 1250, 137 L.Ed.2d 331). As in that case, "The SEC, acting reasonably within its rulemaking authority, has adopted a policy, incorporated in regulations, of permitting the practice" (supra, at 48, 651 N.Y.S.2d 352, 674 N.E.2d 282). This policy would be severely compromised by the application of State common-law agency principles (id., citing Doctor's Assocs. v. Casarotto, 517 U.S. ---, ---, 116 S.Ct. 1652, 1657, 134 L.Ed.2d 902), undermining the regulatory structure devised by Congress (International Paper Co. v. Ouellette, 479 U.S. 481, 107 S.Ct. 805, 93 L.Ed.2d 883).

END OF DOCUMENT

APPENDIX F

DECISION AND ORDER APPEALED FROM [36-45]

FILED
May 10, 1996
County Clerk's Office
New York

SUPREME COURT OF THE STATE OF NEW YORK - - NEW YORK COUNTY

PRESENT: Hon. WALTER M. SCHACKMAN,

The following papers, numbered 1 to 3 were read on this motion to/for DISMISS

Notice of Motion/ Order to	Papers Numbered
Show Cause - Affidavits -- Exhibits	1, 2 + mem
Answering Affidavits -- Exhibits	3 + mem
Replying Affidavits	mem
Cross-Motion NO,	

ESTATE OF DAVID BRAUNSTEIN, et al. v. MERRILL LYNCH, PIERCE, FENNER & SMITH INC., et al.-
11667/94

Upon the foregoing papers, it is ordered that this motion

IS DECIDED IN ACCORDANCE WITH
ACCOMPANYING MEMORANDUM DECISION

Dated: **MAY 7, 1996**

Check one: NON-FINAL DISPOSITION

ESTATE OF DAVID BRAUNSTEIN, et al. v. MERRILL LYNCH, PIERCE, FENNER & SMITH INC., et al.-
11667/94

SUPREME COURT OF THE STATE OF NEW YORK
NEW YORK COUNTY : COMMERCIAL DIVISION

_____ X

THE ESTATE OF DAVID J. BRAUNSTEIN, et al.,	Part 14
Plaintiffs,	Index No.
-against-	11667/94
MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, et al.,	
Defendants.	

_____ X

WALTER M. SCHACKMAN, J.:

In this class action challenging the securities industry's control and use of "free credit balances" in their customer's accounts, defendants move to dismiss the amended complaint pursuant to CPLR 3013 and 3016(b) for failure to plead with the required particularity and detail and for failure to state a cause of action pursuant to CPLR 3211(a) (7).

This court was previously requested to dismiss the original complaint with prejudice on the following grounds: (1) federal preemption, (ii) the causes of action asserted were within the primary jurisdiction of the Securities and Exchange Commission ("SEC"), (iii) failure to a state cause of action for breach of fiduciary duty or unjust enrichment, (iv)

plaintiffs' lack of standing, (v) expiration of the Statute of limitations.

In a memorandum decision and order dated June 7, 1995 (the "Decision"), I denied the motion to dismiss on grounds (i) and (ii) above, but dismissed the 11 page complaint for failure to plead breach of fiduciary duty and unjust enrichment with the particularity required by CPLR 3C16(b) and granted plaintiffs leave to replead. I termed the complaint "very general" and observed that it did not contain any detailed information about the relationship between any plaintiff and any defendant. On July 10, 1995, plaintiff filed their 29-page First Amended Complaint.

Free credit balances are customers' funds held by brokerage firms which are subject to immediate cash payment to customers on demand, generally resulting from sales of securities, dividends, interest, or other transactions. Like the original complaint before it, the amended complaint alleges that the defendants' practice of creating, retaining and profiting from these funds is an unjust enrichment and a breach of fiduciary duty. However, unlike the cursory original complaint, the amended complaint fully satisfies the pleading requirements of CPLR 3013 and 3016(b) because it states in detail the circumstances constituting the wrong complained of and states enough facts from which a breach of fiduciary duty and unjust enrichment-claim may exist sufficient to withstand dismissal under CPLR 3211(a)(7).

As this court previously recognized, the relationship between a stockbroker and its customer in connection with the

broker's handling of the customer's funds, is that of principal and agent and, thus, is fiduciary in nature. (Decision at p.16). As was recognized by my colleague, Justice Herman Cahn, in Greenwald v. Shearson Lehman Brothers, Inc., NYLJ, Nov 4, 1993, at 22, col. 3 (Sup Ct, NY Co),

> Whenever the broker is acting as the agent of the customer, for example, in executing a customer's order or handling customer funds, the customer has the right to assume and to rely on the fact that the broker is acting for his or her benefit at all times during the relationship. (Saboundjian v. Bank Audi (USA), 157 AD2d 278, 283 [lst Dept 1990]; Gilman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 93 Misc 2d 941, 944-45 [NY Sup Ct 1978]; Johnson v. Winslow, 155 Misc 170, 151 [NY Sup Ct 1935], all'd, 246 App Div 800 [lst Dept 1936], all'd, 272 NY 467; Bosio v. Norbay Securities, Inc., 599 F Supp 1563, 1571 [EDNY 1985]).

(See also, Evangelist v. Fidelity Brokerage Services, Inc., AD2d, 637 NYS2d 392 [1st Dept 1996][reversing dismissal of class action complaint against securities broker alleging breach of fiduciary duty resulting from failure to disclose practice of receiving order flow payments from market makers as inducement for placing orders with them]; Feinberg v. Dean Witter Reynolds, Sup Ct, NY County, August 14, 1992, Arber, J., Index No. 11868/92 [fiduciary duty may exist regarding undisclosed $50 service charge on brokerage accounts]).

However, I noted that the area of free credit balances had been partially preempted by the SEC, in particular by SEC Rules 15c3-2 and 15c3-3, which allow broker-dealers to use free credit balances for their own purposes in areas permitted by the SEC.

> To the extent that the balances are thus used, they are not being misused; there has been no breach of trust. The question that arises, then, is whether or not plaintiffs can state, or have stated, a claim for breach of fiduciary duty under the common law because the defendants have not paid plaintiffs recompense for the permitted use of plaintiffs' funds.

(Decision at p.17).

I was previously unimpressed and continue to be unmoved by the defendants' argument that the relationship between securities brokers and customers with respect to the broker's undisclosed gains on free credit balances is analogous to that of a bank and its customer, which is a debtor-creditor relationship.[1] Absent the approval of state

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[1] Aaron Ferer & Sons Ltd. v. Chase Manhattan Bank, 731 F2d 112, 122-[2d Cir 1984]["New York law is clear that the usual relationship of bank and customer is that of debtor and creditor"]; Frouge Corp. v. Chase Manhattan Bank 426 F Supp 794 [SDNY 1976][granting summary judgment to the defendant bank with respect to the-plaintiff's claim for breach of fiduciary duty in connection with profits earned by the bank from customer's deposits into an ordinary commercial account]).

banking authorities, brokers are excluded by New York Stock Exchange Rule 436 from paying interest on credit balances-created solely to earn interest as that is a banking function (2 N.Y.S.E. [CCH] ¶2436 [1990]). Defendants state: "[a]s with banks, broker-dealers merely act as depositories on behalf of their customers when they hold such funds for their customers' accounts." (Defendants' 9/15/95 Mem of Law at p.7). However, unlike a banking relationship where the purpose of the relationship is for one party (the bank) to hold the money placed there by the other party (the customer), in a broker/customer relationship, free credit balances arise as an incidence of other transactions which are the inherent purpose of the account between the parties.

Although I found that plaintiffs may have a breach of fiduciary duty claim here, I found that plaintiffs had not set forth that claim with the particularity required by CPLR 3016(b). In accordance with the court's instructions, the plaintiffs have amended their complaint to set forth more detailed factual allegations about the relationship between themselves and the defendant brokers.

First, the original complaint had merely alleged in a conclusory fashion that plaintiffs maintained investment accounts with the various defendants and deposited monies or securities with these defendants in various accounts. (See, Complaint ¶¶2,5[a], 17). In the Decision, I specified the kinds of information which the amended complaint should contain.

> Plaintiffs should, for example, be able to state, to the best of their belief, whether or not they had formal

> account agreements with defendants, if so, which defendants they dealt with and what the agreements provided for with respect to free credit balances. As to plaintiffs who had no formal agreements with any defendant, they should be able to allege the defendants with which they dealt, the transactions (at least in general or by type) they engaged in with defendants and the bases upon which they so engaged. Plaintiffs should also be able to clarify exactly what they are claiming (e.g., in regard to delays).

(Decision at p. 19, n.3). The amended complaint now sets forth which named plaintiffs maintained investment accounts with which defendant broker/dealer, the names, and the account numbers of the named plaintiffs' accounts, and sets forth examples of dates and amounts of free credit balances in such accounts. (Amended Complaint ¶¶6[a-k], 27).

Second, the original complaint was very vague about the alleged "unlawful and unjust use" of the free credit balances. (See, e.g., Complaint ¶¶21, 23). The amended complaint now specifies that defendants determine unilaterally whether and/or when free credit balances are created and, if created, the length of time the free credit balances are held by the defendants. Plaintiffs also allege that defendants have unjustly delayed the transfer of the funds to the plaintiffs, enabling defendants to further retain and use these funds for their own profit, to the detriment of the plaintiffs. (Amended Complaint ¶3). It is the contention of the plaintiffs that each defendant has the capability to program its computers so that free credit balances need never be kept overnight. (Id. ¶19).

However, the defendants have allegedly adopted methods and procedures whereby the balances are unnecessarily created or left in customer accounts for longer periods of time than necessary. For example, by programming their computers so that free credit balances are not "swept" into the customer's money market funds until after the settlement date of a sales transaction. On the other hand, when a customer purchases a security, the broker typically sweeps the funds out of the customer's account on or before the settlement date. (Id. ¶20).

Third, in ruling on the defendants' federal preemption claim, I noted that there could be conflict between the common law and the SEC if the plaintiffs were seeking recompense for free credit balances maintained exclusively for the earning of interest. (Decision at pp.13-14). However, I found that the issue was not clear since plaintiffs

> have used their opposing memorandum of law in an effort to recast their pleadings. This is better done by amendment that particularizes their claim. If, as appears, plaintiffs are concerned only about free credit balances created by securities transactions or plans therefor, not by depositing for the sake of interest, the pleading ought to say so.

(Id. at p.17). The amended complaint now definitively states that plaintiffs are not concerned about "free credit balances created solely for the purpose of earning interest." (Amended Complaint ¶2).

Finally, the amended complaint addresses its

predecessor's deficiency regarding the question or existence of written account agreements between the named plaintiffs and the various defendants. In dismissing the claim for unjust enrichment, I noted that there can be no quasi-contract if the matter at issue is governed by an express one. (See, Decision at pp.19-20, citing Miller v. Schloss, 218 NY 400, 406-08 [1916]; Smith v. Pagano, 154 AD2d 586, 587-88 [2d Dept 1989], lv denied 76 NY2d 703). If therefore, the plaintiffs signed agreements that stated that interest would not be paid on free credit balances, a quasi-contractual claim would not lie, although if the agreement was silent as to the payment of interest, the plaintiffs may have an arguable claim. (Decision at p.20)

The amended complaint alleges that very few of the defendants' customers sign account agreements with the defendants for cash or non-margin securities accounts[2]; that of those customers who do sign such written account agreements, very few, if any are given copies of the agreements after they have signed and returned them to the defendants. (Amended Complaint ¶23). It is further alleged that none of the plaintiffs have' entered into a contract with any of the defendants which provides that the defendants may reap an economic benefit from the customer's free credit

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[2] Although I am bound to accept this allegation as true for purposes of a motion to dismiss, I note that defendants have acknowledged in prior motion papers and previously during depositions undertaken when this action was pending in Arizona, that not all of their customers had written agreements in connection with their accounts.

balances without an accounting to the customer. (Id. ¶24).

Finally, the amended complaint alleges that the defendants send monthly or quarterly account statements to the plaintiffs. Plaintiffs admit that sometimes, but not always, these periodic statements provide a printed notice on the reverse side advising that "free credit balances may be used in operation of [the Defendant's] business." However, the amended complaint alleges that none of these notices advise or disclose to the plaintiffs that the defendants will obtain and retain economic benefits from such use and not account to the customer for such benefits. (Amended Complaint ¶25). Furthermore, these periodic statements are allegedly deficient because they do not report or identify what credit balances are nor the amount of the customer's free credit balances on hand at any given time. (Id. ¶26). In accordance with the prior Decision, these claims are sufficient to state a claim for unjust enrichment.

It bears repeating the high standard which must be met on a motion which challenges the sufficiency of a complaint. The facts pleaded are presumed to be true and accorded every favorable inference. (Morone v. Morone, 50 NY2d 481, 484 [1980]; Guggenheimer v. Ginzberg, 43.NY2d 268, 275 [1977]; CAE Industries Ltd. v. KPMG Peat Marwick, 193 AD2d 470, 472 [1st Dept 1993]). The issue at this juncture is not whether plaintiffs, claims about the account agreements or lack thereof can be proven, but whether the cause of action can reasonably be implied. (Guggenheimer, 43 NY2d at 275, supra; Cohn v. Lionel Corp., 21 NY2d 559, 562 [1968]).

ESTATE OF DAVID BRAUNSTEIN, et al. v. MERRILL LYNCH, PIERCE, FENNER & SMITH INC., et al.-
11667/94

Plaintiffs were not required to produce the actual agreements that do exist in response to defendants' motion, especially since plaintiffs claim that: these agreements are in defendants' possession. Accordingly, I find that amended complaint sufficiently states a claim for breach of fiduciary duty and unjust enrichment.

For the foregoing reasons, it is hereby

ORDERED that defendants' motion to dismiss the First Amended Complaint is denied; and it is further

ORDERED plaintiffs' counsel if directed to retrieve the original motion papers on the class certification motion, which, although never formally filed with the Clerk's office, has been fully briefed and is now located in my chambers, and have the motion entered in the computer of Room 148A, and that motion together with the rest of this action is hereby respectfully referred to Justice Lewis R. Friedman (Part 11) who has taken over this Commercial Division part.

Dated: May 7, 1996

ENTER:

/s/_____
Walter M. Schackman
JSC

COUNTY CLERK'S OFFICE
NEW YORK
May 10, 1996

APPENDIX G

FIRST AMENDED COMPLAINT [66-94]

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

Index No.: 94/111667

Date Purchased: 4/25/94

IAS Part 14
(Schackman, J.)

FIRST AMENDED CLASS ACTION COMPLAINT

PLAINTIFFS DEMAND A JURY TRIAL

THE ESTATE OF DAVID J. BRAUNSTEIN and ROSEMARIE BRAUNSTEIN; NEIL WEINER; BURTON SOLOMON; SANDRA MALLIEN; JOANN duPONT; PHILIP KARP; CAROLYN GOODWIN as executrix of the ESTATE OF EDITH CAMPER deceased THOMAS McWHORTER; WILLIAM L. NORTON; RUDOLFO XIMENES; AND ROBERT SAPINZON and RUTH SAPINZON, TRUSTEES SAPINZON FAMILY TRUST, on behalf of themselves and all others similarly situated,

Plaintiffs,

vs.

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED (Merrill), PRUDENTIAL SECURITIES INCORPORATED (Prudential), SMITH BARNEY SHEARSON INC. (Smith Barney), KEMPER SECURITIES GROUP INC. and KEMPER SECURITIES, INC. (Kemper), DEAN WITTER REYNOLDS INC. (Witter), ALEX, BROWN & SONS, INC. (Brown), BEAR, STEARNS SECURITIES CORP. (Bear Stearns), CHARLES SCHWAB & CO., INC. (Schwab), KIDDER PEABODY AND CO. INCORPORATED (Kidder), PAINE WEBBER INCORPORATED (PW), LEHMAN BROTHERS, INC. (Lehman),

Defendants.

Plaintiffs, for their First Amended Class Action Complaint, complain and allege as follows:

NATURE OF ACTION

1. This is a Class action brought by citizens and residents of Arizona against the Defendants (hereinafter also referred to as "broker-dealers") who are doing business throughout the United States but who have their principal or major offices and/or operations centers in the State and County of New York. The Plaintiffs and putative class members are customers of one or more of the Defendants. They seek an accounting and restitution for any gain or economic benefit derived and retained by Defendants from Defendants' use of their customers' funds known as "free credit balances." Free credit balances are customers' funds held by broker-dealers which are subject to immediate cash payment to customers on demand, generally resulting from

sales of securities, dividends, interest, or other transactions. The free credit balances addressed by this action are those that exist overnight or longer on the books of the broker-dealer. Plaintiffs do not challenge the right of defendants, in circumstances where there are applicable regulations, to hold their customers' free credit balances in trust, in the manner prescribed and limited by such regulations.

2. Plaintiffs maintained securities accounts with Defendants and deposited moneys or securities with these Defendants in various accounts by several means to purchase, sell, transfer, exchange, or hold securities. Defendants take possession and control of Plaintiffs' moneys and securities when placed in said accounts. Plaintiffs' transactions generate free credit balances in these accounts. This action does not involve free credit balances created solely for the purpose of earning interest. Plaintiffs are also investors who transferred their accounts (which also included free credit balances) from one broker-dealer to another for varying reasons at one time or another.

3. Defendants hold and control their customers' free credit balances, and determine unilaterally whether and/or when free credit balances are created and, if created, the length of time the free credited balances are held as such by Defendants. During the existence of these free credit balances, Defendants use their customers' free credit balances, generate an economic benefit from this use and retain such economic benefit as their own. Defendants have also unjustly delayed the transfer of the Plaintiffs' and Class members' free credit balances, enabling them to further retain and use these free credit balances for their own profit, to the detriment of the

Plaintiffs and the Class members. In essence, Defendants use their customers' property, benefit economically from such uses, and pay nothing for the use or benefit.

4. Plaintiffs and the Class members seek (i) an accounting of all gain and profit derived by the Defendants on these unjustly retained and then used free credit balances; restitution of any gain and profit unjustly obtained by the Defendants as a result of these practices; and (iii) other appropriate equitable and injunctive relief.

5. Plaintiffs seek to represent a Class of all others in the United States who are or have been damaged by the complained of practices of the Defendants.

PARTIES

6. Plaintiffs (residents of Arizona) are customers of Defendants and/or have transacted business with Defendants in a manner creating free credit balances as more fully described herein and are members of the Class they seek to represent.

a. Plaintiffs The Estate of David J. Braunstein and Rosemarie Braunstein are the successors in interest or successor trustees to brokerage accounts held in the name of or for the benefit of David J. Braunstein, either individually, in joint tenancy with rights of survivorship, or as trustee for various retirement and pension plans for Royal Towing Inc. David J. Braunstein died in May 1995. He held such accounts in these capacities with Defendants Merrill

Lynch, Bear Steams (as clearing agent for GKN Securities), Kemper Securities (by its division Bateman Eichler, Hill Richards, Inc.), PaineWebber, and Prudential, all of whom created and used Mr. and Mrs. Braunstein's free credit balances as described herein.

b. Plaintiff Nell Weiner has or has had accounts with Defendant Prudential which created and used his free credit balances as described herein.

c. Plaintiff Burton Solomon has or has had accounts with Defendants Alex. Brown, Kidder Peabody, Merrill Lynch, PaineWebber, Charles Schwab, and Shearson Lehman Brothers which created and used his free credit balances as described herein.

d. Plaintiff Sandra Mallien has or has had accounts with Defendants Kemper and Shearson Lehman Brothers which created and used her free credit balances as described herein.

e. Plaintiff Joanne duPont has or has had accounts with Defendant Dean Witter which created and used her free credit balances as described herein.

f. Plaintiff Philip Karp has or has had accounts with Defendants PaineWebber, Charles Schwab, Shearson Lehman Brothers, and Smith Barney which created and used his free credit balances as described herein.

g. Plaintiff Estate of Edith Camper, deceased, has or has had accounts with Defendants Shearson Lehman Brothers and Smith Barney which created and used her free credit balances as described herein.

h. Plaintiff Thomas McWhorter has or has had accounts with Defendant Kidder Peabody which created and used his free credit balances as described herein.

i. Plaintiff William L. Norton has or has had accounts with Defendants PaineWebber and Charles Schwab which created and used his free credit balances as described herein.

j. Plaintiff Rudolfo Ximenez has or has had accounts with Defendant Dean Witter which created and used his free credit balances as described herein.

k. Plaintiffs Robert Sapinzon and Ruth Sapinzon, Trustees Sapinzon Family Trust have or have had accounts with Defendant Merrill Lynch which created and used their free credit balances as described herein.

7. Defendants are member firms of the New York Stock Exchange and the National Association of Securities Dealers. Defendants have major offices and/or operations in the State and County of New York. Defendants have acted as the broker-dealers to Plaintiffs and Class members in thousands of transactions that are identifiable from Defendants' records. In that role of broker-dealer, Defendants processed and continue to process millions of dollars of

transactions daily involving the purchases, sale, exchange, transfer or holding of securities as described herein. Defendants control a major portion of all security accounts in the United States and thereby have the use of a major portion of all free credit balances in the United States.

a. Defendant Alex. Brown & Sons Incorporated ("Alex. Brown") is a corporation organized and existing under the laws of the State of Maryland. Alex. Brown maintains offices and is registered to do business in the State of New York.

b. Defendant Bear Stearns & Co. ("Bear Stearns") is a corporation organized and existing under the laws of the State of Delaware. Its home office and principal place of business are in New York City.

c. Defendant Dean Witter Reynolds, Inc. ("Dean Witter") is a corporation organized and existing under the laws of the State of Delaware. Its home office and principal place of business are in New York City.

d. Defendants Kemper Securities Group Inc. and Kemper Securities, Inc. ("Kemper") are corporations organized and existing under the laws of the State of Delaware. Their home offices and principal places of business are in Illinois. Kemper is registered to do business and transacts business in the State of New York.

e. Defendant Kidder, Peabody & Co. incorporated ("Kidder Peabody") is a corporation

organized and existing under the laws of the State of Delaware. Its home office and principal place of business are in New York City.

f. Defendant Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch") is a corporation organized and existing under the laws of the State of Delaware. Its home office and principal place of business are in New York City.

g. Defendant PaineWebber Incorporated ("PaineWebber") is a corporation organized and existing under the laws of the State of Delaware. Its principal place of business is in New York City.

h. Defendant Prudential Securities, Inc. ("Prudential") is a corporation organized and existing under the laws of the State of Delaware. Its home office and principal place of business are in New York City.

i. Defendant Charles Schwab & Co., Inc. ("Schwab") is a corporation organized and existing under the laws of the State of California. Schwab maintains offices, is registered to do business in, and transacts business in the State of New York.

j. Defendant Lehman Brothers ("Lehman") is a corporation organized and existing under the laws of the State of Delaware. Its home office and principal place of business is in New York City. Lehman is the successor to the broker-dealer formerly known as

Shearson Lehman Brothers. On July 31, 1993, Shearson Lehman Brothers sold the Shearson retail brokerage business to Primerica Corporation and its subsidiary, Smith Barney, Harris Upham & Co. As a result of the sale, Shearson Lehman Brothers changed its name to Lehman Brothers Inc. and Smith Barney was renamed Smith Barney Shearson Inc. The plaintiffs who had accounts with Shearson Lehman Brothers prior to July 31, 1993, Camper, Karp, Mallien, and Solomon, assert claims herein against the surviving corporation, Lehman Brothers Inc. The plaintiffs whose accounts were transferred as a result of the sale to Primerica, Camper and Karp, also assert claims against Smith Barney Shearson.

k. Defendant Smith Barney Shearson, Inc. is a corporation organized and existing under the laws of the State of Delaware. Its home office and principal place of business are in New York City.

JURISDICTION AND VENUE

8. Defendants are registered to do business in the State and County of New York, have their principal places of business in New York, transact business in New York and/or have substantial contacts and a presence here. The acts complained of occurred, in whole or in part, within the State or County of New York and Defendants have benefitted from their actions here by obtaining and recognizing revenue from Plaintiffs and the Class members in the State of New York.

THE PREDECESSOR ARIZONA ACTION

9. Plaintiffs first filed a class action against these Defendants in Arizona on July 12, 1993. A First Amended Complaint was filed in that action on July 26, 1993. In that action, Plaintiffs sought restitution and damages for use of their free credit balances. (Solomon, et al. v. Kemper, et al., Superior Court of Arizona: Maricopa County, CV 93-11503).

10. Defendants filed a motion to dismiss for forum non conveniens. After limited discovery and a full hearing the Court, in pertinent part, stated:

> Whatever standard is applied in this case, the defendants have established New York to be the more appropriate forum. First, there is no or very little question that New York is an available forum. Second, an analysis of the private and public interests involved points markedly towards New York.

Thereafter, the Court went on to rule as follows:

> The court hereby stays all further proceedings to give the plaintiffs the chance to litigate this case in New York. Should the New York court impose any substantial impediment to or limitation upon that litigation which this court would not impose, this court will consider vacating the stay and denying the motion to dismiss.

The full text of Judge Kamin's order is appended hereto as Exhibit A.

CLASS ALLEGATIONS

11. Plaintiffs bring this action as a Class action pursuant to Article 9 of the New York Civil Practice Law and Rules ("CPLR") on behalf of a Class (the "Class") consisting of and defined as follows:

> All persons or entities in the United States who have, or have had accounts with one or more of the defendants in which they have had free credit balances which existed overnight or longer from which the defendants have received economic benefit for which the defendants have not properly accounted to the plaintiffs. Excluded from the class are the defendants, all employees of the defendants and the members of their immediate families, the subsidiaries and affiliates of the defendants, any trusts of any entities which they control or of which they are the beneficiaries and the heirs, successors or assigns of any of the defendants.

12. The Class is so numerous that joinder of all members is impracticable. Plaintiffs believe there are millions of Class members whose claims, when aggregated, give this Court a sufficient amount to exercise its jurisdiction. The exact number and identity of the Class members is unknown to Plaintiffs at this time but can be identified from records maintained by Defendants. The members of the Class may be notified of the pendency of this action by mail or publication, using a form of notice similar to that customarily used in class actions.

13. Plaintiffs' claims are typical of the claims of the

members of the Class they seek to represent. Plaintiffs and all members of the Class were damaged by Defendants' wrongful conduct in that economic benefit that was derived from the Plaintiffs' and Class members' free credit balances was wrongfully appropriated or retained by Defendants. Plaintiffs do not have interests which are antagonistic to or in conflict with one another or with those they seek to represent as the relief sought is the same for each Class member.

14. Plaintiffs will fairly and adequately protect the interests of the Class members they seek to represent and have retained counsel competent and experienced in complex class litigation who are ready, willing and able to undertake all professional work required as well as the financial obligations of this case.

15. A class action is superior to other available methods for the fair and efficient adjudication of this controversy. Joinder of all Class members is impracticable. Since the damage suffered by some individual Class members may be relatively small, the expense and burden of individual litigation make it impracticable and unduly burdensome, if not impossible, for the Class members, individually, to redress the wrongs suffered by them at the hands of Defendants.

16. Common questions of law or fact exist as to all Class members and these common issues predominate over questions affecting solely individual Class members. Among the questions of law or fact common to the Class are:

a. whether Defendants participated in and pursued the common course of conduct complained of;

b. whether Defendants were unjustly enriched at the expense of Plaintiffs and Class members as a result of Defendants' retention of economic benefits derived from their use of the Plaintiffs' and Class members' free credit balances thereby entitling Plaintiffs and Class members to restitution and other appropriate relief;

c. whether Defendants breached their fiduciary duties to Plaintiffs and Class members by retaining the economic benefits derived from their use of the Plaintiffs' and Class members' free credit balances and not accounting for such economic benefits or reimbursing the Plaintiffs and the Class;

d. whether the Class members have sustained damages, and if so, the proper measure of such damages; and

e. whether Defendants should be enjoined from continuing their improper conduct described here.

17. Defendants are the parties opposing the Class and each has acted on grounds generally applicable to the Class. Defendants - all represented by the same counsel of record, who has filed one set of papers on behalf of all Defendants - have taken identical positions in this action, thereby making appropriate final legal and injunctive relief or corresponding declaratory relief with respect to the Class as a whole.

ACTS UPON WHICH CLAIMS FOR RELIEF ARE BASED

18. Plaintiffs and Class members maintain and/or have maintained securities accounts with Defendants. Plaintiffs and Class members placed funds (or securities) under the control of or in the possession of Defendants thereby permitting Defendants to engage in transactions such as the buying, selling, exchanging, transferring, or safekeeping of securities on behalf of Plaintiffs and Class members. In some instances, Defendants acted as the clearing agent for other broker-dealers. Each of these transactions results in the creation of free credit balances. In the course of conducting these transactions and handling these accounts, free credit balances are created. Free credit balances are also created when third parties make deposits into the accounts (e.g. bond interest from a bond issuer or stock dividend from a corporate issuer). A customer moving an account from one broker-dealer to another gives rise to a free credit balance. The transferring broker-dealer liquidates the money market fund in the account and then holds it as a free credit balance until the transfer is completed.

19. Free credit balances need never be kept overnight. Each Defendant has the capability to program its computers so that free credit balances are not kept overnight.

20. The Defendants, however, have adopted methods and procedures whereby free credit balances are unnecessarily created or left in customer accounts for longer periods of time than necessary. Such actions benefit the defendants in that they have the use of free credit balances they would not otherwise have and prevent Plaintiffs and Class members from having the beneficial use of their money. Typical of these

methods and procedures is the programming of computers to delay the sweep of free credit balances into the customers' money market fund, often until after the settlement date of a sales transaction or receipt of a dividend or interest payment. Free credit balances are routinely left in the account overnight, or for three days over a weekend, or longer, before being swept. On the other hand, when a customer purchases a security, the broker-dealer typically sweeps funds out of the customers' account on or before the settlement date. Free credit balances are thus created and maximized by Defendants for their own use, amounting to millions of dollars each day. The economic benefit from the use of these funds should go to the Plaintiffs and Class members, not to the Defendants.

21. The Defendants hold their customers' free credit balances in trust and, thus, are fiduciaries or trustees in relation to the free credit balances in the Plaintiffs' and Class members' accounts. Defendants have failed to account to Plaintiffs or Class members for the economic benefit obtained by the Defendants from their creation and use of Plaintiffs' and Class members' free credit balances.

22. The Securities Exchange Commission ("SEC")has regulated and restricted the use of customer free credit balances by broker-dealers for the purpose of protecting the investing public. Subject to various rules and regulations for the protection of the investing public, broker-dealers are permitted to use free credit balances in the operation of their securities business. The SEC, while pertaining restricted use of free credit balances, has not regulated the relationship between the customer and the broker-dealer with respect to accounting for and the payment of the economic benefit

obtained from the use of free credit balances and the Plaintiffs and Class members' are entitled to their common law rights in connection with the benefits so obtained.

23. Upon information and belief, very few, if any, of the Defendants' customers sign contracts or account agreements with the Defendants for cash or non-margin securities accounts. Upon information and belief, of those customers who do sign contracts or account agreements, very few, if any, are given copies of such contracts or account agreements after they have signed and returned them to the defendants. Any such contract or account agreement is a boiler-plate document prepared entirely by each Defendant, is a contract of adhesion, with no input from the customer.

24. None of the Plaintiffs or Class members has entered into a contract with any of the Defendants which provides that the Defendants will or may use the customer's free credit balances in a manner which would produce an economic benefit to the Defendant and allow the Defendant to keep such economic benefit without accounting to the customer therefor.

25. Defendants send monthly or quarterly account statements to the Plaintiffs and Class members. The Defendants sometimes, but not always, provide a printed notice on the reverse side of these periodic statements advising that "free credit balances may be used in the operation of [the Defendant's] business" but none of these notices advise or disclose that the Defendants will obtain and retain economic benefits from such use and not account to the customer for such benefits nor does the notice advise the

Plaintiffs or Class members of the nature and extent of the economic benefit actually derived by such Defendants.

26. The Defendants' periodic account statements contain numerous categories on the front of the statements representing a summary of the cash and securities in the Plaintiffs' and Class members' accounts as of the date of the statement and a summary of the transactions conducted during the period covered by the statement. None of the Defendants describe, report or identify in these periodic statements to the Plaintiffs and Class members what free credit balances are nor the amount of the Plaintiffs' or Class members' free credit balances on hand at any given time.

27. The following lists the names and account numbers of the named Plaintiffs' accounts with Defendants and sets forth examples of dates and amounts of free credit balances in such accounts:

a. David J. Braunstein & Rose Marie Braunstein JTWROS: Merrill Lynch Account No. 412-14F50:

i. Free credit balance of $508.26 existed from December 30, 1989 to March 20, 1990; Merrill Lynch did not sweep of free credit balances for three months.

b. David J. Braunstein & Rose Marie Braunstein JTWROS: Kemper Securities (on behalf of its division Batman Eichler, Hill Richards, Inc.), Account No. TV65-1706-3188:

i. Free credit balance of $5,915.79 existed from October 30, 1989 to November 6, 1989; stock sold with a settlement date of October 30, 1989, but check for the proceeds was not issued until November 6, 1989.

ii. Free credit balance of $3,698.00 existed from October 30, 1989 to November 6, 1989; stock sold with a settlement date of October 30, 1989, but check for proceeds was not issued until November 6, 1989.

iii. Free credit balance of $508.26 existed from November 9, 1989 to November 21, 1989; money market fund was liquidated; free credit balance transfer out of account delayed.

c. David J. Braunstein & Rose Marie Braunstein JTWROS: Bear Stearns, carrying account at GKN Securities Account No. 573-16670:

i. Free credit balance of $43.00 existed from January 28, 1993 to June 30, 1993; free credit balance held for five months.

d. Royal Towing, Inc./FBO David Braunstein Retirement Plan dated June 12, 1989: Kemper Securities (on behalf of its division Bateman Eichler, Hill Richards, Inc.), Account No. TV65-1706-3189:

i. Free credit balance of $86.91 existed from April 25, 1990 to May 4, 1990; dividend was received

after funds were transferred to another broker-dealer; Defendant held funds as free credit balances.

e. Royal Towing/FBO David J. Braunstein Retirement Plan dated December 31, 1987; Prudential Bache Account No. ONS-RO6500-06:

i. Free credit balance of $56.00 existed from January 19, 1989 to January 31, 1989; dividend received; Prudential held as free credit balance for twelve days.

f. FBO David J. Braunstein SEP; Merrill Lynch Account No. 412 93U56:

i. Free credit balance of $19,127.00 existed from March 1, 1991 to March 4, 1991; sale of stock; proceeds received on Friday, not swept into money market account until following Monday (example of Defendants' institutional weekending).

ii. Free credit balance of $10,107.00 existed from May 9, 1991 to May 10:1991; sale of stock, proceeds were not swept into money market account until next day.

g. FBO David J. Braunstein SEP; PaineWebber Account No. UX-72904:

i. Free credit balance of $24,158.65 existed from January 24, 1992 until January 27, 1992; proceeds from sale of stock; PaineWebber held as free

credit balances over the weekend.

h. Joanne A. duPont: Dean Witter Account No. 102-03467 I:

i. Free credit balance of $2,050.00 existed from May 3, 1991 to May 6, 1991; sale of stock; Dean Witter held proceeds over weekend.

ii. Free credit balance of $1,038,883.00 existed from July 18, 1991 to July 19, 1991; sale of federal securities,, receipt of federal funds; Dean Witter held funds until next day.

iii. Free credit balance of $220.00 existed from July 31, 1991 to August 7, 1991; Dean Witter delayed transfer of dividend received after account transferred to another broker-dealer.

i. Carolyn Goodwin, personal representative Estate of Edith Camper: Shearson Lehman Brothers Account No. 539-07422-10-135:

i. Free credit balance of $6,000 existed from March 26, 1990 to March 30, 1990; proceeds received on March 26, Defendant held proceeds as free credit balances for four days.

ii. Free credit balance of $40.00 existed from August 1, 1990 to November I, 1990; dividend received on August 1 but Defendant held as free credit balances until November 1, 1990.

j. Carolyn Goodwin personal representative Estate of Edith Camper: Smith Barney Shearson Account No. 05A-122955:

i. Free credit balance of $675.24 existed from January 18, 1992 to February 4, 1992; dividend received on January 18, 1992, Defendant held as free credit balances until February 4, 1992.

k. Philip Karp: Charles Schwab Account No. PX4929-9159:

i. Free credit balance of $368.25 existed from March 24, 1993 to April 5, 1993; money order received and not swept for twelve days.

ii. Free credit balance of $14.07 existed from November 29, 1993 to June 30, 1994; dividend received; Schwab held as free credit balances for seven months

1. Philip Karp: PaineWebber IRA Account GA 20996-58:

i. Free credit balance of $7,507.35 existed from June 25, 1993 to June 28, 1993; weekending of sale proceeds of in-house mutual funds.

ii. Free credit balance of $12.00 existed from July 2, 1992 to January 29, 1993; dividend received; PaineWebber held as free credit balances for seven months.

m. Philip Karp: Shearson Lehman Brothers IRA Account No. 331-65307-10-22:

i. Free credit balance of $2,170.93 existed from January 4, 1994 to January 5, 1994; Sales proceeds from in-house mutual fund held overnight.

ii. Free credit balance of $44.68 existed from March 26, 1993 to March 29, 1993; weekending of mutual fund dividend.

n. Sandra Mallien: Kemper Securities (for Bateman Eichler, Hill Richards, Inc.) Account No. TV91-5162-2332:

i. Free credit balance of $139,574.00 existed from July 2, 1991 to July 15, 1991; funds arose as a result of liquidation of money market account; Kemper delayed transfer to new broker-dealer.

ii. Free credit balance of $297.00 existed from July 15, 1991 to July 31, 1991; dividends received after account transferred to new broker-dealer held as free credit balances pending transfer to new broker-dealer.

o. Sandra Mallien: Shearson Lehman Brothers IRA Account No. 331-63353-18-200:

i. Free credit balance of $2,000.00 existed from September 27, 1991 to September 30, 1991; weekending of IRA contribution.

p. Sandra Mallien: Shearson Lehman Brothers, Custodial Account for Christopher M. Davis UAZUGMA Account No. 331-366888-10-200:

i. Free credit balance of $8,099.86 existed from July 15, 1991 to July 22, 1991; credit received from transfer of account; held for one week.

q. Thomas McWhorter: Kidder, Peabody Custodial IRA Rollover Account No. 82P-T1662-106:

i. Free credit balance of $24,397.72 existed from July 14, 1993 to July 15, 1993; proceeds of mutual fund liquidation held overnight.

ii. Free credit balance of $24,322.72 existed from July 15, 1993 to July 28, 1993; Liquidated mutual funds were to be transferred to another broker-dealer on July 14; Kidder held as free credit balances until July 28, 1993.

r. William L. Norton: PaineWebber Account No. GA87504-57:

i. Free credit balance of $2.34 existed from August 3, 1989 to November 2, 1989; money market dividend; PaineWebber held as free credit balances for three months.

ii. Free credit balance of $26.20 existed from November 20, 1990 to December 3, 1990; transfer of funds held pending transfer of account to another

broker-dealer.

s. William L. Norton: Charles Schwab Account No. PX6718-4984:

i. Free credit balance of $2,222.50 existed from October 30, 1992 to November 2, 1992; money transferred in from another broker-dealer, held over weekend.

t. William L. Norton: Charles Schwab IRA Account No. PX67184977:

i. Free credit balance of $32,727.01 existed from February 10, 1993 to February 11, 1993; money transferred in from another broker-dealer held overnight.

ii. Free credit balance of $27,808.62 existed from October 26, 1993 to October 27, 1993; money transferred in from another broker-dealer held overnight.

iii. Free credit balance of $5,457.18 existed from September 22, 1993 to September 23, 1993; proceeds from sale o securities held overnight.

u. William L. Norton: PaineWebber IRA Account No. GA76310-57:

i. Free credit balance of $7,000.00 existed from May 15, 1991 to May 16, 1991; Proceeds from

redemption of Treasury bonds held overnight.

ii. Free credit balance of $21,668.76 existed from October 31, 1991 to November 4, 1991; proceeds from IRA Rollover, held over weekend.

iii. Free credit balance of $6,000.00 existed from November 15, 1991 to November 18, 1991; proceeds from maturation of Treasury bond, held over weekend.

v. Robert Sapinzon: Merrill Lynch IRA Account No..411-96831:

i. Free credit balance of $49,503.58 existed from April 6, 1993 to April 27, 1993; liquidated money market funds held pending transfer to another broker-dealer.

ii. Free credit balance of $108,690.86 existed from April 19, 1993 to April 27, 1993; proceeds of securities sale held pending transfer to another broker-dealer.

iii. Free credit balance of $435.04 existed from April I, 993 to April 15, 1993; dividends held pending transfer to another broker-dealer.

w. Robert Sapinzon and Ruth Sapinzon, Trustees Sapinzon .Family .Trust: Merrill Lynch Account No. 411-96384:

i. Free credit balance of $847.00 existed

from March 3, 1993 to March 8, 1993; proceeds from United States Social Security check held for five days.

x. Burton Solomon: Merrill Lynch IRA Account No. 549-89529:

i. Free credit balance of $50,022.87 existed from June 11, 1991 to July 12, 1991; proceeds from IRA rollover held overnight.

ii. Free credit balance of $53,475.99 existed from July 15, 1991 to July 16, 1991; proceeds from IRA rollover held overnight.

y. Burton Solomon: Alex. Brown, carrying Account of Peacock, Hilsop, Staley & Given, Inc., IRA Rollover Account No. 705-80005:

i. Free credit balance of $32,000.00 existed from October 7, 1991 to October 9, 1991; proceeds from IRA rollover.

ii. Free credit balance of $40,000.00 existed from January 8, 1992 to January 10, 1992; proceeds from sale of security.

iii. Free credit balance of $94.72 existed from January 10, 1992 to January 13, 1992; proceeds from mutual fund dividend, held over weekend.

z. Burton Solomon: Kidder, Peabody IRA Rollover Account No. 82P-T 1959-097:

i. Free credit balance of $10,000.00 existed from February 12, 1992 to February 18, 1992; proceeds from IRA rollover (from Federal Reserve Bank) held as free credit balances for six days.

ii. Free credit balance of $1,332.22 existed from March 25, 1992 to March 30. 1992; dividend held as free credit balance.

iii. Free credit balance of $585.00 existed from May 11, 1992 to May 18, 1992; interest from US municipal bond held as free credit balance for one week,

aa. Burton Solomon: Shearson Lehman Brothers IRA Rollover Account No. 331-63226-13-200:

i. Free credit balance of $196,120.62 existed from May 26, 1992 to May 27, 1992; funds transferred from another broker-dealer.

ii. Free credit balance of $10,000.00 existed from June 1, 1992 to June 2, 1992; IRA rollover proceeds.

iii. Free credit balance of $92,408.65 existed from June 12, 1992 to June 25, 1992; funds transferred from another broker-dealer, held-over weekend.

bb. Burton Solomon IRA Rollover: PaineWebber Account No. GA 24170 69:

i. Free credit balance of $108,753.60 existed from June 21, 1994 to June 22, 1994; Federal fund deposit held overnight.

ii. Free credit balance of $3,189.41 existed from August 23, 1994 to August 24, 1994; cash deposit held overnight.

iii. Free credit balance of $46,923.75 existed from August 22, 1994 to August 23, 1994; Proceeds from redemption of Federal Farm Credit Bank bond and interest held overnight.

cc. Burton Solomon and Ruth U. Solomon Co-Trustees Solomon Inter Vivos Trust dated January. 8, 1990: PaineWebber Account No. GA 24497 69:

i. Free credit balance of $5,939.38 existed from July 1, 1994 to July 5, 1994; municipal bond interest held over weekend.

dd. Neil Weiner: Prudential Bache IRA Account No. ABQ-RO8451-55:

i. Free credit balance of $3,655.28 existed from December 21, 1990 to December 24, 1990; proceeds from sale of security, held over weekend.

ii. Free credit balance of $1,169.00 existed from March I, 1991 to March 4, 1991; proceeds of in-house mutual fund sale, held over weekend.

iii. Free credit balance of $160.00 existed from May 15, 1991 to May 17, 1991; distributions of federal funds and from in-house limited partnership, held for two days.

iv. Free credit balance of $52.90 existed from October 22, 1990 to October 30, 1990; distribution from in-house limited partnership held for eight days.

ee. Rudolfo S. Ximenez: Dean Witter IRA Account No. 250-088198:

i. Free credit balance of $3,636.36 existed from November 16, 1992 to January 12, 1993; proceeds from sale of stock held for two months.

28. The free credit balances set forth in paragraph 27 above, are examples of the many free credit balances in the Plaintiffs' and Class members' accounts which belonged to Plaintiffs and Class members, which Defendants held in trust on behalf of Plaintiffs and Class members, and which Defendants used for their own economic benefit without accounting to Plaintiffs and Class members for such benefits.

CLAIMS FOR RELIEF

FIRST CAUSE OF ACTION
(UNJUST ENRICHMENT)

29. Plaintiffs repeat and reallege each of the statements in Paragraphs 1 through 27 as if fully set forth

herein.

30. Defendants were unjustly enriched to the extent of all gain and profit derived from the use of Plaintiffs' and the Class members' free credit balances. Defendants publicly report that substantial percentages of their annual earnings result from the use of their customers' free credit balances. Defendants have no legal or equitable right to profit or gain economic benefit from the use of free credit balances without compensating Plaintiffs and Class members. Plaintiffs and Class members are and were therefore damaged by these acts of Defendants.

31. Defendants loaned a portion of the retained free credit balances to other customers at relatively high interest rates for Defendants' benefit and profit. This method of operation and business practice by the Defendants reduces their need to borrow federal or commercial funds at going rates of interest, and therefore, becomes a free or very inexpensive source of working capital for Defendants, enabling them to earn large returns on Plaintiffs' and Class members' free credit balances. There is no authority or legal or equitable justification for these acts and Defendants are not entitled to retain the benefits of such use, particularly where Defendants create and maximize the length of time free credit balances exist for their own use to the detriment of Plaintiffs and Class members.

32. Plaintiffs and the Class members have not waived any right to benefits derived from their free credit balances. Nor have Plaintiffs and the Class members consented to these acts or to forego their rights to these benefits.

33. Plaintiffs and Class members are entitled to recover any gain or profit received by Defendants during the period of the use by Defendants of Plaintiffs' and the Class members' free credit balances and to have restitution thereof and other appropriate legal and equitable relief.

SECOND CAUSE OF ACTION (BREACH OF FIDUCIARY DUTY)

34. Plaintiffs repeat and reallege each of the statements in Paragraphs 1 through 32 as if fully set forth herein.

35. At the time Defendants received and took control and possession of Plaintiffs' and the Class members' accounts and free credit balances, Defendants were or became fiduciaries and trustees with respect to those accounts and the free credit balances therein.

36. Defendants, as fiduciaries and trustees over Plaintiffs' and the Class members' free credit balances, owed fiduciary duties to Plaintiffs and the Class members, such as loyalty, accountability, disclosure and restraint from the misuse of Plaintiffs' and Class members' free credit balances. These duties include prohibition against self-dealing and the duty to protect the customers' interests.

37. Defendants, as broker-dealers and trustees over their customers' funds, are also under a fiduciary duty to deal fairly and in complete candor with their customers concerning the matters entrusted to them, and not to misappropriate the economic benefits of the property of the *cestui que* trust.

38. As fiduciaries or trustees over plaintiffs' and the Class members' free credit balances, Defendants are accountable for any profit made by them arising out of their administration of these funds, even if the profit does not result from a breach of trust, and whether or not those funds and free credit balances came into Defendants' possession and control voluntarily or by consent or otherwise.

39. Defendants have not disclosed to Plaintiffs and the Class members that they profit from their customers' free credit balances in their possession. Nor have Defendants obtained Plaintiffs' or the Class members' informed consent to retain the profits from their use of the Plaintiffs' and/or Class members' free credit balances.

40. By committing the acts complained of, Defendants breached their fiduciary duties to Plaintiffs and Class members.

41. Plaintiffs and the Class members were thereby damaged in that the use of their free credit balances was denied to them while Defendants profited and/or Defendants retained an economic benefit which rightfully belongs to Plaintiffs and the Class members.

WHEREFORE, Plaintiffs, on behalf of themselves and the other members of the Class, demand judgment against each Defendant as follows:

A. Determining that this action is a proper Class Action as defined and maintainable under CPLR Article 9;

B. Awarding Plaintiffs and all Class members damages in an amount determined by a full accounting for the use of Plaintiffs' and Class members' free credit balances; for restitution thereof and impressing a trust in the amount due the Plaintiffs and Class members;

C. For pre-judgment interest on those amounts of damages as determined by the Court;

D. For both a temporary and permanent injunction - enjoining Defendants from continuing the practices complained of and/or a declaratory judgment that these acts are unlawful;

E. Awarding Plaintiffs and Class members the costs of this suit, including reasonable attorneys' fees, accountants' and experts' fees and other disbursements;

and

F. Ordering such other and further relief at law or equity as may be just and proper.

Dated: July 10, 1995
New York, New York

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ESTATE OF DAVID BRAUNSTEIN, et al. v. MERRILL LYNCH, PIERCE, FENNER & SMITH INC., et al.

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APPENDIX H

THE U.S. CONSTITUTION

ARTICLE VI.

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made or which shall be made under the Authority of the United States, shall be the supreme Law of the Land: and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

APPENDIX I

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

THE ESTATE OF DAVID J. BRAUNSTEIN and ROSEMARIE BRAUNSTEIN; NEIL WEINER; BURTON SOLOMON; SANDRA MALLIEN; JOANN duPONT; PHILIP KARP; CAROLYN GOODWIN as executrix of the ESTATE OF EDITH CAMPER deceased THOMAS McWHORTER; WILLIAM L. NORTON; RUDOLFO XIMENES; AND ROBERT SAPINZON and RUTH SAPINZON, TRUSTEES SAPINZON FAMILY TRUST, on behalf of themselves and all others similarly situated,

Plaintiffs,

vs.

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED (Merrill), PRUDENTIAL SECURITIES INCORPORATED (Prudential), SMITH BARNEY SHEARSON INC. (Smith Barney), KEMPER SECURITIES GROUP INC. and KEMPER SECURITIES, INC. (Kemper), DEAN WITTER REYNOLDS INC. (Witter), ALEX, BROWN & SONS, INC. (Brown), BEAR, STEARNS SECURITIES CORP. (Bear Stearns), CHARLES SCHWAB & CO., INC. (Schwab), KIDDER PEABODY AND CO. INCORPORATED (Kidder), PAINE WEBBER INCORPORATED (PW), LEHMAN BROTHERS, INC. (Lehman),

Defendants.

Index No. 111667/94

NOTICE OF
ENTRY OF ORDER

PLEASE TAKE NOTICE that the within is a true copy of the Decision and Order of the Supreme Court, Appellate Division, First Department, in this action, duly entered in the office of the Clerk of the Supreme Court, New York County, on or after the 22nd day of April 1997.

ESTATE OF DAVID BRAUNSTEIN, et al. v. MERRILL LYNCH, etc., et al. - No. 111667/94

Dated: New York, New York
April 24, 1997

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ESTATE OF DAVID BRAUNSTEIN, et al. v. MERRILL LYNCH, etc., et al. - No. 111667/94

Ellerin, J.P., Nardelli, Rubin, Mazzarelli, JJ.

60355-
60356 The Estate of David J. Braunstein, et al.,
Plaintiffs-Respondents,

Frank Lewis

-against-

Merrill Lynch, Pierce, Fenner & Smith, Incorporated, etc., et al.,
Defendants-Appellants.

A. Robert Pietrzak

- - - - - -

The Securities Industry Association
Amicus Curiae

Peter Buscemi

Order of the Supreme Court, New York County (Walter Schackman, J.), entered May 10, 1996, which denied defendants' motion to dismiss the amended complaint, unanimously reversed, on the law, without costs, the motion granted and the amended complaint dismissed. The Clerk is directed to enter judgment in favor of the defendants-appellants dismissing the amended complaint. Appeal from the order of the same court and Justice, entered on or about June 7, 1995, which granted defendants' motion to dismiss the complaint, with leave to replead, unanimously dismissed as academic in view of the foregoing.

This class action, predicated on State common-law principles of breach of fiduciary duty and unjust enrichment,

seeks an accounting and restitution of any benefit received by defendants from use of "free credit balances" belonging to the class members. "Free credit balances" are defined by regulation of the Securities and Exchange Commission (SEC) as "liabilities of a broker or dealer to customers which are subject to immediate cash payment to customers on demand, whether resulting from sales of securities, dividends, interest, deposits or otherwise" (17 CFR §240.15c3-3[a] [8]). Plaintiffs theorize that defendants' application of these funds to their business operations violates defendants' fiduciary duties to their customers.

Under the Supremacy Clause of the United States Constitution (art VI, cl 2), plaintiffs' claims are preempted by federal law (see, Gibbons v Ogden, 22 US [9 Wheat] 1, 210-211), which provides that the SEC shall prescribe rules and regulations "to provide safeguards with respect to financial responsibility and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers' securities and the carrying and use of customers' deposits or credit balances" (Securities Exchange Act, 15 USC §78o[c] [3]). Federal law expressly permits broker/dealers to use free credit balances in connection with such customer-related activities as financing margin purchases, short sales and failed deliveries (17 CFR §240.15c3-3a) .

In a similar case, in which the plaintiffs complained of the broker/dealers' practice of receiving "order flow payments" (remuneration for routing customers' orders for execution by wholesale dealers), the Court of Appeals held that such common-law claims "are preempted by the 1975

amendments to the Securities Exchange Act and implementing SEC regulations" (Guice v Charles Schwab & Co., 89 NY2d 31, 39, cert denied 1997 US Lexis 1683). As in that case, "the SEC, acting reasonably within its rule-making authority, has adopted a policy, incorporated in regulations, of permitting the practice" (supra, at 48). This policy would be severely compromised by the application of State common-law agency principles (id., citing Doctor's Assocs. v Casarotto, 517 US.. , 116 S Ct 1652, 1657), undermining the regulatory structure devised by Congress (International Paper Co. v Ouellette, 479 US 481).

THIS CONSTITUTES THE DECISION AND ORDER OF THE SUPREME COURT, APPELLATE DIVISION, FIRST DEPARTMENT.

ENTERED: APRIL 22, 1997

/s/_____
Catherine Wolfe
CLERK

APPENDIX J

ARTICLE 56

APPEALS TO THE COURT OF APPEALS

SUMMARY OF ARTICLE

§5601. Appeals to the court of appeals as of right.

(b) Constitutional grounds.

* * *

§5601. Appeals to the court of appeals as of right.

(b) Constitutional grounds. An appeal may be taken to the court of appeals as of right:

1. from an order of the appellate division which finally determines an action where there is directly involved the construction of the constitution of the state or of the United States; and

APPENDIX K

New York County Clerk's Index No. _____

Court of Appeals
of the
State of New York

THE ESTATE OF DAVID J. BRAUNSTEIN and ROSEMARIE BRAUNSTEIN; NEIL WEINER; BURTON SOLOMON; SANDRA MALLIEN; JOANN duPONT; PHILIP KARP; CAROLYN GOODWIN as executrix of the ESTATE OF EDITH CAMPER deceased; THOMAS McWHORTER; WILLIAM L. NORTON; RUDOLFO XIMENES; AND ROBERT SAPINZON and RUTH SAPINZON, TRUSTEES SAPINZON FAMILY TRUST, on behalf of themselves and all others similarly situated,

Plaintiffs-Appellants,

-against-

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED (Merrill); PRUDENTIAL SECURITIES INCORPORATED (Prudential); SMITH BARNEY SHEARSON INC. (Smith Barney); KEMPER SECURITIES GROUP INC. and KEMPER SECURITIES, INC. (Kemper); DEAN WITTER REYNOLDS, INC. (Witter); ALEX. BROWN & SONS, INC. (Brown); BEAR, STEARNS SECURITIES CORP. (Bear Stearns); CHARLES SCHWAB & CO., INC. (Schwab); KIDDER,

PEABODY AND CO. INCORPORATED (Kidder); PAINEWEBBER INCORPORATED (PW); and LEHMAN BROTHERS INC. (Lehman),

Defendants-Respondents.

MOTION OF PLAINTIFFS-APPELLANTS FOR LEAVE TO APPEAL TO THE COURT OF APPEALS

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TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES iii

TABLE OF NEW YORK AUTHORITIES iv

I. NOTICE PURSUANT TO 22 NYCRR 500.11(d)(1)(i) 1

II. QUESTIONS PRESENTED FOR REVIEW PURSUANT TO NYCRR 500.11(d)(1)(ii) 4

QUESTION INVOLVED ON APPEAL NO. 1

Does the complete absence of any federal standard or regulation governing the right to receive the benefits from the use of "free credit balances" by broker-dealers acting as fiduciaries for their customers in regard to "free credit balances" evidence intent by Congress or the SEC to preempt and extinguish by virtue of the Supremacy Clause (Art. VI, cl. 2) of the United States Constitution any and all common law rights and remedies expressly preserved by the Securities Exchange Act for the customers of broker-dealers for redress in regard to the entitlements to the benefits from the use of "free credit balances"? 4

QUESTION INVOLVED ON APPEAL NO. 2

Is this Court's decision in Guice v. Schwab, 89 NY2d 31, 674 N.E.2d 282, 651 N.Y.S.2d 352 (Ct. App. 1996), cert. denied, __ U.S. __, 117 S.Ct. 1250, 137 L.Ed. 2d 331 controlling and dispositive with respect to the issues in this case? 4

III. PROCEDURAL HISTORY/STATEMENT OF TIMELINESS PURSUANT TO 22 NYCRR 500.11(d)(1)(iii) 5

IV. JURISDICTIONAL STATEMENT PURSUANT TO NYCRR 500.11(d)(1)(iv) 7

V. THE COURT OF APPEALS SHOULD GRANT LEAVE TO APPEAL DUE TO THE NOVEL QUESTIONS OF GREAT PUBLIC IMPORTANCE PRESENTED AND, ADDITIONALLY, BECAUSE THE QUESTIONS OF LAW RAISE MAJOR PUBLIC POLICY CONSIDERATIONS THAT AFFECT THE RIGHTS OF MANY OTHERS THAN THE ACTUAL LITIGANTS 8

A. The Misuse by Broker-Dealers of Free Credit Balances Has Been Previously Condemned By New York Courts 8

B. Public Policy Considerations Warrant Review By The Court Of Appeals Because The Defendants-Respondents' Actions As Fiduciaries Affect Tens Of Millions Of People 9

C. The Supremacy Clause Does Not Preempt Claims For an Accounting Based Upon Breach of Fiduciary Duty and Unjust Enrichment 11

1. The Standards for Preemption as Articulated By This Court and the United States Supreme Court Are Inconsistent With the Decision of the First Department 11

2. Congress Did Not Expressly Preempt Common Law Claims of Breach of Fiduciary Duty and Unjust Enrichment Against Broker/Dealers (Defendants-Respondents) or Claims Regarding Free Credit Balances by Their Customers (Plaintiffs-Appellants) . 13

a. Guice Is Inapposite and Not Controlling . 14

b. The Mere Existence of Some Federal Regulation Permitting the Use of "Free Credit Balances" Belonging to Customers of Broker-Dealers By Broker-Dealers Does Not Evidence Intent to Preempt State Regulation of State Law Claims for Redress by Customers of Broker-Dealers For Benefits

Improperly Arrogated by Broker-Dealers to Themselves From Such Use 16

1. New York Cases and Law 16

2. Federal Cases and Law 19

3. Securities Exchange Commission Rules and Regulations 20

c. Primary Jurisdiction Or Preemption Is Narrowly Employed In Cases Regarding The Fixing Or Validity Of A Commercial Rate or Tariff 21

VI. CONCLUSION 21

TABLE OF AUTHORITIES

Page(s)

Building & Const. Trade Council v. Associated Builders,
113 S. Ct. 1190 (1993) 12

California v. ARC Am. Corp.,
490 U.S. 93 (1989) 12

California Fed. Sav. & Loan Ass'n v. Guerra,
479 U.S. 272 (1987) 11, 12

Cipollone v. Liggett Group, Inc.,
112 S. Ct. 2608(1992) 12, 19

City of New York v. Job-Lot Pushcart,
88 N.Y.2d 163, 666 N.E. 2d 537,
643 N.Y.S. 2d 944 (Ct. of Appeals 1996) . . 17, 18

Conway v. Icahn & Co.,
16 F.3d 504, 509 (2d Cir. 1994) 6

CSX Transp., Inc. v. Easterwood,
113 S. Ct. 1732 (1993) 12, 19

Dahl v. Charles Schwab & Co.,
No. 93-16272 (Minn. D.C., 4th District
April 7, 1994) 21

English v. General Elec. Co.,
496 U.S. 72 (1990) 11, 12, 19

Estate of Braunstein, et al. v.
Merrill Lynch, Pierce, Fenner & Smith, Inc.,
657 N.Y.S.2d 12 (S.Ct., A.D.
1st Dept. 1997) 13

Far East Conf. v. United States,
342 U.S. 570 (1952) 21

Ghandour v. Shearson Lehman Hutton, Inc.,
174 A.D.2d 317, 570 N.Y.S.2d 541
(1st Dep't), appeal dismissed,
79 N.Y.2d 823, 580 N.Y.S.2d 201 (1991) 18

Gibbons v. Ogden,
22 US [9 Wheat] 1 6

Gilman v. Merrill Lynch, Pierce, Fenner &
Smith, Inc.,
101 Misc. 2d 655, 421 N.Y.S.2d 794
(S. Ct. N.Y. Co. 1979) and Id.,
93 Misc. 2d 941. 404 N.Y.S.2d 258
(Sup. Ct. N.Y. Co. 1978) 6, 8, 9, 12

Gordon v. New York Stock Exch.,
422 U.S. 659 (1975) 21

Goya Foods, Inc. v. Tropicana Prod., Inc.,
846 F.2d 848 (2d Cir. 1988) 21

Greenwald v. Shearson Lehman Bros., Inc.,
N.Y.L.J. Nov. 4, 1993, at 22
(Sup. Ct. N.Y. Co.) 6

Guice v. Charles Schwab,
89 NY2d 31, 674 N.E.2d 282,
651 N.Y.S.2d 352 (Ct. App. 1996),
cert. denied, __ U.S. __, 117 S.Ct. 1250,
137 L.Ed. 2d 331 . . . . . 2, 4, 14, 15, 16, 22

Horst v. W.T. Cabe & Co.,
[1977 Transfer Binder] Fed. Sec. L. Rep.
(CCH) ¶96,213 (S.D.N.Y. 1977) 12

Khalid Bin Talal Bin Abdul Azaiz Al Seoud v.
E.F. Hutton & Co.,
720 F. Supp. 671 (N.D. Ill. 1989) 19

Mallen v. Merrill Lynch Futures, Inc.,
623 F. Supp. 203 (N.D. Ga. 1985) 20

Maryland v. Louisiana,
451 U.S. 724 (1981) 12

Monroe-Livingston Sanitary Landfill v.
Town of Caledonia,
51 N.Y.2d 679, 417 N.E.2d 78,
435 N.Y.S.2d 966 (Ct. App. 1980) 17, 18

National Common. Ass'n v. American Tel. & Tel. Co.,
813 F. Supp. 259 (S.D.N.Y. 1993) 21

People v. Cook,
34 N.Y.2d 100, 312 N.E.2d 452,
356 N.Y.S.2d 259 (Ct. App. 1974) 17

People v. Mercer Hicks Corp.,
4 Misc. 2d 55, 155 N.Y.S.2d 740
(Sup. Ct. N.Y. Co. 1956),
aff'd, 3 A.D.2d 708, 160 N.Y.S.2d 806
(1st Dep't 1957) 6

People v. Pymm,
76 N.Y.2d 511, 563 N.E.2d 1,
561 N.Y.S.2d 687 (Ct. App. 1990) 16, 17

Pettigrew v. Oppenheimer & Co.,
582 F. Supp. 98 (D. Mass. 1984) 19

Rice v. Santa Fe Elevator Corp.,
331 U.S. 218 (1947) 12

Rivoli Trucking Corp. v. American Exp. Lines, Inc.,
11 N.Y.2d 1013, 229 N.Y.S.2d 758 (1962) . . . 11

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479 U.S. 130 (1986) 11

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464 U.S. 238, 104 S.Ct. 615,
78 L.Ed.2d 443 (1984) 17

United States v. Western Pac. R. Co.,
352 U.S. 59 (1956) 21

ESTATE OF DAVID BRAUNSTEIN, et al. v. MERRILL LYNCH, ETC., et al. - No. 111667/94

West 158th Street Garage Corporation v. State, 10 N.Y.S. 2d 990, 256 A.D. 401 (Supr. Ct., A.D. 1939) 3

FEDERAL STATUTES AND RULES

Supremacy Clause of the United States Constitution, Art. VI, cl. 2 . . . . . 2, 4, 6, 11

Section 28(a) of the Securities Exchange Act of 1934 . . . . . 13, 20

Securities Exchange Act, 15 USC §78o [c] [3] 7

Occupational safety and Health Act of 1970 (29 U.S.C. §651 et seq.) 16

Section 19 of the 1933 Securities Act contains a similar "savings" clause, 15 U.S.C. § 77r (1993) 13

SEC Rel. No. 34-9388, 1971 SEC LEXIS 231 at * 14 . 13

SEC Rel. No. 18262, 4 Fed. Sec. L. Rep. (CCH) ¶25,134B, at 18,327 (Nov. 17, 1981) 15

The Honorable Frank Horton, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2027, at *1 (March 12, 1983) . . . 15

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Notice to Broker-Dealers Concerning Interest-Bearing Free Credit Balances, Exchange Act Release No. 34-18262. [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 25,134B at 18,327 (Nov. 17, 1981) ("SEC Ret. No. 34-18262") (SA 58-61) 12, 14, 15

Rule 15c3-2, 17 C.F.R. § 240.15c3-2 (1993) 13, 20

17 CFR §240.15c3-3a 7

Rule 15c3-3(c)(1), 17 C.F.R. § 240.15c3-3(e)(1) (1993) 7

17 C.F.R. § 240.15c3-3(f) 7

17 C.F.R. § 240.15c3-3(j)(2) 7

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STATE RULES

CPLR 5602(a)(1)(i) 1, 7

CPLR 5602(b)(i) 7

22 NYCRR 500.11 (d)(1)(i) 1

22 NYCRR 500.11(d)(1)(ii) 4

22 NYCRR 500.11 (d)(1)(iii) 5

22 NYCRR 500.11(d)(1)(iv) 7

LEGISLATIVE AND REGULATORY HISTORY
(Authorities)

SEC, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., Ch. III.D.1.a. at 10 (1964) 13

In re Newman (Ann), SEC Ruling, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,177 at 80,545 (Div. of Trading and Markets May 6, 1971) 15

Proposal to Adopt Rules 15c3-3 and 15c3-4 Under the Securities Exchange Act of 1934 and to Amend Rules 8c-1 and 15c2-1 Under that Act, Exchange Act Release No. 34-9388, 1971 SEC LEXIS 231 at * 16-17 (Nov. 8, 1971) ("SEC Rel. No. 34-9388") 20

SELF-REGULATORY ORGANIZATION RULES

NYSE Interpretation Handbook, NYSE Rule 436, at 4380 (Sept. 1981) 15

NYSE Rule 436, 2 NYSE Guide ¶ 2436 (1996) 15

TEXTS

11 N.Y. Jur. 2d Brokers ¶45 at 392-93 (1981) 6

ESTATE OF DAVID BRAUNSTEIN, et al. v. MERRILL LYNCH, ETC., et al. - No. 111667/94

EXHIBITS

Exhibit 1	Order granting Braunstein leave to appeal from the Decision and Order of the Appellate Division, First Department, entered on September 11, 1997 and served on Braunstein with notice of entry on September 18, 1997	1, 6
Exhibit 2	Motion to Dismiss Plaintiffs' First Amended Class Action Complaint in Solomon, et al. v. Kemper Securities Group, Inc., et al. for Forum Non Conveniens, dated September 30, 1993	2
Exhibit 3	Class Action Complaint in Solomon, et al. v. Kemper Securities Group, Inc., et al., filed in Superior Court of Maricopa County (Arizona) on July 12, 1993	5
Exhibit 4	April 22, 1997 Order of Supreme Court, Appellate Division, First Department overruling Judge Schackman's Order of May 10, 1996, and dismissing plaintiffs-appellants' claims on constitutional grounds (reported as 657 N.Y.S.2d 12)	3, 4, 6, 7

ESTATE OF DAVID BRAUNSTEIN, et al. v. MERRILL LYNCH, ETC., et al. - No. 111667/94

Exhibit 5	June 3, 1997 letter from the New York Court of Appeals, requesting a letter brief why plaintiffs-appellants believed they had an appeal as of right	7
Exhibit 6	June 10, 1997 plaintiffs-appellants' letter brief to the New York Court of Appeals, in response to the June 3, 1997 letter (see Exhibit 5)	6

[* Exhibits not included in this petition.]

ESTATE OF DAVID BRAUNSTEIN, et al. v.
MERRILL LYNCH, ETC., et al. - No. 111667/94

I. NOTICE PURSUANT TO 22 NYCRR 500.11 (d)(1)(i)

PLEASE TAKE NOTICE that, upon the annexed supporting papers, Plaintiffs-Appellants Estate of David J. Braunstein, et al. ("Braunstein"), will move this Court at the Court of Appeals Hall in Albany, New York, on Monday, November 3, 1997 at the opening of Court, or as soon thereafter as counsel may be heard, for an Order pursuant to CPLR 5602(a)(1)(i) and Court of Appeals Rule 500.11(d) granting Braunstein leave to appeal from the Decision and Order of the Appellate Division, First Department, entered on September 11, 1997, (reported at and served on Braunstein with notice of entry on September 18, 1997 (Exhibit 1), on the grounds that the questions presented by this case involve novel issues of great public importance which affect millions of persons other than the litigants, to wit:

> WHETHER BROKER-DEALERS, I.E., THOSE COMPANIES (DEFENDANTS-RESPONDENTS HEREINAFTER ALSO REFERRED TO AS "BROKERS" OR "BROKER-DEALERS") THAT CONTROL THE ASSETS OF THEIR CUSTOMERS (PLAINTIFFS-APPELLANTS HEREINAFTER ALSO REFERRED TO AS "CUSTOMERS") FOR USE IN THE EXECUTION OF SECURITY TRADES FOR PLAINTIFFS-APPELLANTS, CAN BREACH THEIR FIDUCIARY DUTIES TO PLAINTIFFS-APPELLANTS AND UNJUSTLY ENRICH THEMSELVES BY KEEPING ALL BENEFITS FLOWING FROM THE USE THAT CASH PORTION OF SUCH ASSETS THAT ARE

FUNDS HELD IN A FIDUCIARY AND TRUST RELATIONSHIP BY BROKER-DEALERS AND WHICH REPRESENT FUNDS DUE CUSTOMERS UPON DEMAND (SUCH FUNDS KNOWN IN THE BROKERAGE BUSINESS AS "FREE CREDIT BALANCES" WHICH ARE GENERATED IN CUSTOMERS ACCOUNTS THROUGH SECURITY TRADES, PAYMENT OF DIVIDENDS AND INTEREST, DELAYED TRANSFER OF ACCOUNTS, ETC.) WITHOUT PERMISSION OF THEIR CUSTOMERS AND WITHOUT ANY STATE COMMON LAW REMEDIES BEING LEFT AVAILABLE TO THOSE CUSTOMERS FOR REDRESS FOR THOSE BREACHES OF FIDUCIARY DUTIES AND RESULTING UNJUST ENRICHMENT?

The issues are particularly important given the centrality of New York as the home to the securities industry and the fact that other states look to New York

[p. 1]

for decisions on precisely these issues. Indeed, this case was originally filed in State Court in Arizona before defendants-respondents (hereinafter also referred to as broker-dealers) successfully stayed the Arizona Action on forum non conveniens grounds, arguing essentially that New York is the center of the securities industry. The defendants-respondents' papers filed in Arizona, arguing for dismissal on forum non conveniens grounds virtually demand some guidance on these major issues from this court. In successfully arguing that Arizona should decline jurisdiction despite overwhelming contacts to Arizona, defendants-

respondents stated that:

> A New York court would have far fewer problems adjudicating this action. New York courts are not only much more familiar with the applicable law, almost all of the witnesses and documents are subject to the subpoena power of the New York courts. The burden of adjudicating this action, involving millions of non-residents and the law of not less than seven foreign jurisdictions, should not be shouldered by Arizona taxpayers and courts, which are already overburdened. While it is possible for an Arizona Court to apply foreign law, it is far more convenient for it to be applied by a court in the state whose law controls. See Coonley, 173 Ariz. at 533, 844 P. 2d at 1183. Like the private interests of the parties, the public interest factors also favor a New York forum for the resolution of this case. (Exhibit 2, pages 14-15)

It would be an unfortunate result indeed if the Court of Appeals were to let stand a decision by the Appellate Division, First Department wrongly equating this case with Guice v. Charles Schwab, 89 NY2d 31, 674 N.E.2d 282, 651 N.Y.S.2d 352 (Ct. App. 1996), cert. denied, __ U.S. __, 117 S.Ct. 125Q, 137 L.Ed. 2d 331, thereby endorsing a federal preemption of plaintiffs-appellants' state claims under the Supremacy Clause of the United States Constitution, Art. VI, cl. 2. The First Department concluded that this case is preempted by Federal law, but offered virtually no guidance

on these novel and important issues.[1] Moreover, the underpinning of the Appellate Division's ruling is based completely on an erroneous understanding and misconception of plaintiffs-appellants' complaint, in which they sum up the issue as follows:

> Plaintiffs theorize that defendants' application of these funds [free credit balances] to their business operations violates defendants' fiduciary duties to their customers. Estate of Braunstein, et al. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 657 N.Y.S.2d 12, 13 (S.Ct., A.D. 1st Dept. 1997).[2]

On the contrary, plaintiffs-appellants' complaint is about broker-dealers' improperly earning profits and capturing any and all benefits associated in any way with the use of customers' free credit balances without accounting to the

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[1] Absent appropriate guidance from this court, there is nothing to stop the theoretical possibility that a nearly identical complaint could be brought against some or all of the defendant-respondents in another state. If that state were to deny a transfer to New York on forum non conveniens grounds, the case would proceed on the merits in that state, without the guidance of New York's highest court. As the defendants made abundantly clear in their forum non conveniens papers, this would be an unfortunate and unintended result.

[2] Plaintiffs-Appellants will use the official citation for the Order of the Appellate Division. (Attached as Exhibit 4)

customers for those benefits or even informing the customers of these benefits. It is not about, nor has it ever been about, broker-dealers' simply using free credit balances in their "business operations." That distinction is real, and it is fundamental to plaintiffs-appellants' right to prosecute their complaint in state court. This assumption is the linchpin of the Appellate Division's ruling, and it is wrong. Therefore, Court of Appeals review is warranted.

Where litigation presents issues of great public interest the Court of Appeals should grant leave to appeal.

> The Court of Appeals grants leave to an aggrieved party to prosecute an appeal from a unanimous decision of the Appellate Division which finally determines an action or special proceeding whenever it will further the "interest of substantial justice." West 158th Street Garage Corporation v. State, 10 N.Y.S. 2d 990, 991, 256 A.D. 401 (Supr. Ct., A.D. 1939).

[p. 3]

The investing public seeks guidance from this court on these issues in a clear and definitive manner. Plaintiffs-appellants, thereby, respectfully request that this court grant leave to appeal in the "interest of substantial justice."

II. QUESTIONS PRESENTED FOR REVIEW PURSUANT TO NYCRR 500.11(d)(1)(ii)

QUESTION INVOLVED ON APPEAL NO. 1

Does the complete absence of any federal standard or

regulation governing the right to receive the benefits from the use of "free credit balances" by broker-dealers acting as fiduciaries for their customers in regard to "free credit balances" evidence intent by Congress or the SEC to preempt and extinguish by virtue of the Supremacy Clause (Art. VI, cl. 2) of the United States Constitution any and all common law rights and remedies expressly preserved by the Securities Exchange Act for the customers of broker-dealers for redress in regard to the entitlements to the benefits from the use of "free credit balances"?

QUESTION INVOLVED ON APPEAL NO. 2

Is this Court's decision in Guice v. Schwab, 89 NY2d 31, 674 N.E.2d 282, 651 N.Y.S.2d 352 (Ct. App. 1996), cert. denied, __ U.S. __, 117 S.Ct. 1250, 137 L.Ed. 2d 331, controlling and dispositive with respect to the issues in this case?

The First Department's Order answered these questions in the affirmative, and held that the subject claims were federally preempted, thereby leaving the plaintiffs-appellants as well as millions of those entities similarly situated without any form of relief - either state or federal - for the recovery of unjust profits and gains generated by the very broker-dealers (defendants-respondents) upon whom their customers relied and trusted. Judge Schackman, in his opinion dated May 10, 1996 (R 36-45), found that the Amended Complaint (R 66-94) properly upheld the Breach of Fiduciary Duty and Unjust Enrichment (R 45). This holding stands undisturbed in the opinion of the Supreme Court, Appellate Division, First Department, dated April 22, 1997

(Exhibit 4). Consequently, this Motion presents significant and novel questions of major public

[p. 4]

importance effecting millions of brokerage house customers who are the victims of this pervasive, national practice.

III. PROCEDURAL HISTORY/STATEMENT OF TIMELINESS PURSUANT TO 22 NYCRR 500.11 (d)(1)(iii)

Plaintiffs-appellants originally filed suit in state court in Arizona on July 12, 1993. The case - in substance - complained that the defendants-respondents had engaged in a national pattern of conduct and practice that intentionally delayed payment of benefits rightfully belonging to their customers' (plaintiffs-appellants) in order to benefit themselves through the unfettered use of customer funds (Exhibit 3). On September 30, 1993, defendants-respondents moved to dismiss the case on forum non conveniens grounds, arguing that New York was a more appropriate jurisdiction. On November 1, 1993, the motion was granted (R 57-61). On April 25, 1994, plaintiffs-appellants filed suit in New York state court (R 46-56). Defendants-respondents filed a motion to dismiss on various grounds, including Federal preemption and for failure to state claims (R 62-64). On June 7, 1995, Justice Schackman of the Supreme Court rejected the defendants-respondents arguments regarding Federal preemption and other Constitutional issues, but granted the motion to dismiss for failure to state a claim (R 9-30). On July 10, 1995, plaintiffs-appellants filed an Amended Complaint, and again the defendants-respondents filed a motion to dismiss on all grounds (R 66-94 and R 95-96). On

May 7, 1996, Justice Schackman denied defendants-respondents' motion to dismiss on all grounds (R 36-45) and specifically found that broker-dealers owed a fiduciary duty to their customers in regard to free credit balances:

> [T]he relationship between a stockholder and its customer in connection with the broker's handling of the customer's funds, is that of principal and agent and, thus, is fiduciary in nature. (emphasis added) (R 38)
>
> [p. 5]

This finding was in consonance with New York law. See Gilman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 93 Misc. 2d 941, 944, 494 N.Y.S.2d 258, 262 (S.Ct. N.Y. Co. 1978) ("[T]he relationship between a stockbroker and his customer is one of principal and agent [cite omitted]. The broker, once he has received his customer's funds, is a fiduciary with respect to those funds."); Greenwald v. Shearson Lehman Bros., Inc., N.Y.L.J. Nov. 4, 1993, at 22 (Sup. Ct. N.Y. Co.) ("whenever the broker is acting as the agent of the customer, for example, in executing a customer's order, *or handling customer funds*, the customer has the right to assume and rely on the fact that the broker is acting for his or her benefit at all times during the relationship") (emphasis added); and 11 N.Y. Jur. 2d Brokers ¶ 45 at 392-93 (1981) ("The relationship between a stockbroker and his customer is that of principal and agent and is fiduciary in nature, *especially where the customer deposits money with the broker for the purchase of securities or deposits securities with the*

broker for sale or exchange.") (emphasis added).[3]

On September 30, 1996, defendants-respondents appealed from that Order (R 1-4). On April 22, 1997, the Appellate Division, First Department overruled the trial court and dismissed plaintiffs-appellants' claims, on Constitutional grounds only. Braunstein, 657 N.Y.S.2d 12. (Attached as Exhibit 4). The Order of the Appellate Division stated as follows:

> Under the Supremacy Clause of the United States Constitution (art VI, cl 2), plaintiffs' claims are preempted by federal law (see, Gibbons v. Ogden, 22 US [9 Wheat] 1, 210-211), which provides that the SEC shall prescribe rules and regulations "to provide safeguards with respect to financial responsibility and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers'
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> [p. 6]
>
> securities and the carrying and use of customers' deposits or credit balances" (Securities Exchange Act, 15 USC §78o [c] [3], Federal law expressly permits

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[3] Accord People v. Mercer Hicks Corp., 4 Misc. 2d 55, 58, 155 N.Y.S.2d 740, 744 (Sup. Ct. N.Y. Co. 1956), aff'd, 3 A.D.2d 708, 160 N.Y.S.2d 806 (1st Dep't 1957); Conway v. Icahn & Co., 16 F.3d 504, 509 (2d Cir. 1994).

> broker/dealers to use free credit balances in connection with such customer-related activities as financing margin purchases, short sales and failed deliveries (17 CFR §240.15c3-3a). Braunstein, 657 N.Y.S.2d at 13. (Exhibit 4, page 59)

Due to the language of the Appellate Division's Order, plaintiffs-respondents believed that they had an appeal as of right under CPLR 5602(b)(i), because of the centrality of the constitutional issues presented by the defendants-respondents and accepted by the Appellate Division. On June 3, 1997, plaintiffs-respondents received a letter from the Court of Appeals, requesting a letter brief indicating why plaintiffs-appellants believed they had an appeal as of right. (Exhibit 5) On June 10, 1997, plaintiffs-appellants filed a letter brief with the Court of Appeals. (Exhibit 6) On September 18, 1997, plaintiffs-appellants were served with a notice of entry from the Court of Appeals denying the appeal as of right on the grounds that no substantial constitutional issue was presented. (Exhibit 1) Plaintiffs-appellants now seek leave to appeal and have timely filed this notice and Motion for Leave.

IV. JURISDICTIONAL STATEMENT PURSUANT TO NYCRR 500.11(d)(1)(iv)

The decision and Order of the Appellate Division, First Department, which is the subject of this Motion and the proposed appeal finally determine the underlying action. Thus this court has jurisdiction of this motion and of the proposed appeal pursuant to CPLR §5602(a)(1)(i).

V. THE COURT OF APPEALS SHOULD GRANT LEAVE TO APPEAL DUE TO THE NOVEL QUESTIONS OF GREAT PUBLIC IMPORTANCE PRESENTED AND, ADDITIONALLY, BECAUSE THE QUESTIONS OF LAW RAISE MAJOR PUBLIC POLICY CONSIDERATIONS THAT AFFECT THE RIGHTS OF MANY OTHERS THAN THE ACTUAL LITIGANTS

A. The Misuse by Broker-Dealers of Free Credit Balances Has Been Previously Condemned By New York Courts

There are other important issues, not only for plaintiffs-appellants and others not parties hereto but in similar situations, but of national importance, involving public policy and attacking a nefarious practice that should be halted. This litigation is similar to one that occurred twenty years ago. New York courts ruled that Merrill Lynch--a defendant-respondent here--could not continue a scheme to take advantage of the "float" and the many benefits resulting therefrom and the artificially lengthened use of customers' funds, by issuing checks to its New York customers drawn on a California bank, in an age where paper checks, and not electronic transfers, were the norm. In language that is equally applicable to this case--especially since the practice complained of here is merely a technological update of this same practice (i.e., using other people's money without

appropriate compensation to the owners of the money) the Supreme Court held:

> A final word is appropriate. Unless a class action is permitted, the rights of Merrill Lynch's customers are not likely to be redressed and the Court, by default, will have placed its imprimatur on a practice which, at least, should be the subject of careful and painstaking litigation. *If the practice is wrong, if it represents the breach of a fiduciary relationship, it ought to be stopped. Public policy demands that the practice be subject to judicial scrutiny.* (emphasis added) Gilman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 101 Misc. 2d 655, 421 N.Y.S.2d 794 (S. Ct. N.Y. Co. 1979) and Id., 93 Misc. 2d 941. 404 N.Y.S.2d 258 (Sup. Ct. N.Y. Co. 1978).

Here, as in Gilman, the practice regarding "free credit balances" is wrong and should be

[p. 8]

stopped. The Supreme Court (Schackman, J.) had found that common law claims of unjust enrichment and breach of fiduciary duty had been properly pled and are well asserted claims under New York common law. (R 36-45)

B. Public Policy Considerations Warrant Review By The Court Of Appeals Because the Defendants-Respondents' Actions As Fiduciaries Affect Tens of Millions of People

The public policy issues involved in this putative class action are considerably more far reaching than those in Gilman. Plaintiffs-appellants here complain of a national industry-wide practice in the securities industry that has literally taken billions of dollars from tens of millions of securities customers (R 70, R 74). Were this practice only inflicted on the unfortunate few, then the overwhelming public policy considerations might not exist. In this case, however, virtually every individual who has had an account with one of the defendants-respondents has been damaged whenever they have had a free credit balance created as a result of a securities transaction. (R 67-68)

The broker-dealers accomplish this objective by creating and manipulating free credit balances to ensure delays in transmittal to customers and to further ensure the flow of benefits from the use of those funds to themselves, which are funds held by a fiduciary for others and which arise when a customer sells a security or receives a dividend or an interest payment or otherwise receives or deposits funds in his or her account. When, as in most cases, the customer has a money market account, the brokers unnecessarily delay sweeping customer funds into the interest bearing account. When a customer transfers accounts from one broker-dealer to another, the broker-dealer unnecessarily delays the transfer; delays in the receipt of dividends and interest and their

[p. 9]

subsequent credit or transmittals in kind to customers is a common and uniform practice. In short, they engage in a host of schemes to create and maximize a "float" on the customers' money which unjustly enriches them at the customers' expense; as the broker is then able to borrow less from their

working capital sources, thereby saving on interest payments and using such funds to create revenue by lending them to their customers in margin accounts at interest. These are practices to which the defendants-respondents have admitted, and they defend their actions by arguing: (1) it is an industry-wide practice that they have engaged in for years; and (2) the SEC does not prohibit the practice, even though instantaneous transmittal of these funds can be made to customers or to customers' benefit. The defendants-appellants have opted for the former.

Most free credit balances are no longer held by a broker-dealer "as a matter of [customer] choice and convenience" as they were twenty or thirty years ago when securities transactions were not computerized. See Securities Exchange Commission ("SEC"), Report of Special Study of Securities Markets, H.R. Doc. No. 88-95, Ch. I.D.2.a. at 393-94 (1963); SIA Br. at 3, 23. **(SA 27-37)** Now, however, free credit balances are calculated by the brokers' computer systems instantaneously and on a daily, if not hourly, basis by the press of a button and they become a source of capital to the broker-dealers - all benefits therefrom are lost to their customers. **(SA 76-78)** There can be no motive in this age of electronic communication and transmission of funds for unnecessarily creating[4] free credit balances other than to maximize the "float" and

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[4] Unnecessary creation of free credit balances occurs, for example, when broker-dealers program their computers to delay by a day or more sweeps of received funds into the customer's money market account.

unjustly enrich themselves in direct violation of their duties as fiduciaries. Yet, based on the Appellate Division's ruling, plaintiffs-appellants are without a state or federal remedy.

C. The Supremacy Clause Does Not Preempt Claims For an Accounting Based Upon Breach of Fiduciary Duty and Unjust Enrichment

1. The Standards for Preemption as Articulated By This Court and the United States Supreme Court Are Inconsistent With the Decision of the First Department

Under the Supremacy Clause, U.S. Const. art. VI. cl. 2 - the only ground given by the First Department for preemption - federal law can preempt the application of state common law in only three circumstances. English v. Genera' Elec. Co., 496 U.S. 72, 78-79 (1990). First, Congress can express in the statute its clear intent to preempt state law and the exact extent to which preemption occurs. Id. Second, preemption can occur, in the absence of explicit statutory preemptive language, when Congress implicitly indicates an intent to "occupy an *entire field* of regulation to the exclusion of state law." Id. (emphasis added). The chief indication of implicit intent to preempt state law is when Congress has legislated so comprehensively that it has left no room for supplementary state legislation. R.J. Reynolds Tobacco Co. v. Durham Co., 479 U.S. 130, 142 (1986). Finally, state common law may be preempted if it "actually conflicts" with federal law. English, 496 U.S. at 79. Conflict preemption

occurs either when compliance with both the state and federal laws is "physically impossible" or "where it stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." English, 496 U.S. at 79; California Fed. Sav. & Loan Ass'n v. Guerra, 479 U.S. 272, 281 (1987).

[p. 11]

Preemption of state law is not favored. English, 496 U.S. at 91; California Fed. Sav. & Loan Ass'n v. Guerra, 479 U.S. at 281. In fact, there is a long standing presumption *against* finding, federal preemption of state law in areas traditionally regulated by the states. English, 496 U.S. at 79; CSX Transp., Inc. v. Easterwood, 113 S. Ct. 1732, 1737 (1993); Building & Const. Trade Council v. Associated Builders, 113 S. Ct. 1190, 1194, 1198 (1993); California v. ARC Am. Corp., 490 U.S. 93, 101 (1989); Maryland v. Louisiana, 451 U.S. 724, 746 (1981) (consideration under Supremacy Clause starts with basic assumption that Congress did not intend to displace state law). Thus, preemption will not lie unless it "is the clear and manifest purpose of Congress." Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947). Accord, Cipollone v. Liggett Group, Inc., 112 S. Ct. 2608, 2618(1992).

Courts have consistently treated claims involving free credit balances as state, not federal, claims. See, e,g, Horst v. W.T. Cabe & Co., [1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,213 (S.D.N.Y. 1977) (claim that broker refused to surrender to customer that customer's free credit balances); Gilman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 101 Misc. 2d 655, 421 N.Y.S.2d 794 (S. Ct. N.Y. Co. 1979) and Id., 93 Misc. 2d 941, 404 N.Y.S.2d 258 (Sup. Ct.

N.Y. Co. 1978) (certified class of customers entitled to a return of the profits realized through broker's practice of withholding free credit balances).

The SEC has also expressly stated -- on numerous occasions -- that payment for the use of free credit balances is not a matter of federal regulatory concern. Notice to Broker-Dealers Concerning Interest-Bearing Free Credit Balances, Exchange Act Release No. 34-18262 [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 25,134B at 18,327 (Nov. 17, 1981) ("SEC Ret. No. 34-18262") (SA 58-61); In re Newman (Ann),

[p. 12]

SEC Ruling, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,177 at 80,545 (Div. of Trading and Markets May 6, 1971) (SA 116-117). That pronouncement, and others referred to hereinafter at pp. 15, 16 by the SEC, alone should resolve this motion in Plaintiffs' favor as there is no federal regulatory scheme involving free credit balances.

2. Congress Did Not Expressly Preempt Common Law Claims of Breach of Fiduciary Duty and Unjust Enrichment Against Broker/Dealers (Defendants-Respondents) or Claims Regarding Free Credit Balances By Their Customers (Plaintiffs-Appellants)

Section 28(a) of the Securities Exchange Act of 1934 expressly states that "the rights and remedies provided by this title shall be *in addition* to any and all other rights and

remedies that may exist at law or in equity," and further provides that state Securities Commissions may have jurisdiction over "any person insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder." 15 U.S.C. §78bb(a) (1993) (emphasis added).[5] Congress and the SEC expressly recognized and allowed state authority to remain with respect to the issues raised by these claims.[6]

The SEC, in language that casts aside all doubt that it did not intend to preempt all aspects of the use of free credit balances, has specifically stated, on more than one

[p. 13]

occasion, that "the payment of interest by broker-dealers on free credit balances that arise as an incidence of customer securities activities is a business matter between a broker-dealer and its customer and normally *will not raise*

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[5] Section 19 of the 1933 Securities Act contains a similar "savings" clause, 15 U.S.C. § 77r (1993).

[6] See, e.g., SEC Rel. No. 34-9388, 1971 SEC LEXIS 231 at * 14 ("It should be emphasized that the reserve provisions of proposed Rule 15c3-3 ... in no way purport to affect or diminish the rights of any customer under existing applicable law in his relationship with his broker-dealer with respect to his funds and securities."); SEC, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., Ch. III.D.1.a. at 10 (1964) (recognizing "the importance of the rules and regulations *of various state* and federal regulatory agencies as well as those of the exchanges and the NASD in providing rights and protection for customers" in connection with the "nature of agreements between broker/dealers and their customers") (emphasis added).

regulatory concerns." SEC Rel. No. 34-18262, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 25,134B at 18,327 (Nov. 17, 1981) (emphasis added) (SA 58-61). Just as courts may not find state measures preempted in the absence of clear evidence of Congressional and SEC intent, so must courts give full effect to evidence that Congress and the SEC considered and sought to preserve the states' coordinating regulatory role in the federal scheme. California v. F.E.R.C., 495 U.S. 490 (1990).

a. Guice is Inapposite And Not Controlling

In arriving at its decision in Guice v. Charles Schwab, 89 NY2d 31, 674 N.E.2d 282, 651 N.Y.S.2d 352 (Ct. App. 1996), cert. denied, __ U.S. __, 117 S.Ct. 1250, 137 L.Ed. 2d 331 this court engaged in a careful analysis of the regulatory history of the practice of order flow payments. The plaintiffs sought common law remedies for failure of the defendants to provide full and frank disclosure of order flow payment benefits. This court found that the plaintiffs had stated actionable claims for the disclosure deficiencies. But the court also found that the SEC, as part of the authority given it by the 1975 National Market legislation, had conducted a decade-long monitoring and rule making endeavor concerning order flow payments. The court pointed out that the SEC had arrived at disclosure requirements after carefully balancing competing concepts. The holding of the court in Guice was that permitting state common law claims concerning inadequate disclosure in the face of specific disclosure requirements promulgated by the SEC would thwart the objectives of Congress and therefore were preempted.

Unlike order flow payments, the SEC has not monitored the misuse by broker-dealers of their customers' free credit balances nor has it promulgated any rule stating that broker/dealers are free to create and unnecessarily extend the existence of free credit balances, thereby unjustly enriching themselves. On the contrary, the SEC has, on several occasions, unequivocally stated that the payment for the use of customers' free credit balances is not a matter of federal regulatory concern -- but rather a "business matter between a broker-dealer and its customers and will normally not raise regulatory concerns."[7] **(SA 116, 117)** Various SEC No-Action Letters demonstrate that federal laws and the SEC neither "require" nor "object" to the payment of interest on free credit balances.[8] **(SA 116-123)**

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[7] SEC Rel. No. 18262, 4 Fed. Sec. L. Rep. (CCH) ¶25,134B, at 18,327 (Nov. 17, 1981); In re Newman (Ann), SEC Ruling, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶78,177, at 80,545 (Div. of Trading and Markets May 6, 1971). (SA 116, 117)

[8] The Honorable Frank Horton, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2027, at *1 (March 12, 1983) **(SA 118)**; White, Weld & Co., SEC No-Action Letter, 1974 SEC No. Act. LEXIS 42, at *2 (Aug. 19, 1974). **(SA 121)** See also NYSE Rule 436, 2 NYSE Guide ¶ 2436 (1996); NYSE Interpretation Handbook, NYSE Rule 436, at 4380 (Sept. 1981) ("Interest may be paid on 'free' credit balances left with a member organization for the purpose of reinvestment or temporarily awaiting investment. . . ."), as quoted in SEC Rel. No. 34-18262, 4 Fed. Sec. L. Rep. (CCH) ¶25,134B, at 18,327-4 n. 6. **(SA 60)**

As the trial court (Schackman, J) found in the order dated June 7, 1995 (R 9-30):

> "This is not a situation in which the SEC has examined the matter on the merits and declined to require that a benefit be paid because of the agency's conclusion that nonpayment of the benefit to the customer is in the best interests of the marketplace overall, as in the case of order flow payments. Here the SEC has simply taken a hands-off approach, stating repeatedly that the matter is one between the customer and broker-dealer and not of regulatory concern."

The Court below, relying erroneously on Guice held that this action was similarly preempted by the 1970 amendments to the Securities Exchange Act and regulations

[p. 15]

promulgated thereunder. The court below failed to recognize that the order flow payment practice involves the broker commission structure, an area that has always been regulated by the SEC, and a specific practice which has been monitored and studied by the SEC for many years. The details of that study **(SA 184-187)**, and of requirements fashioned by the SEC as early as 1977 **(SA 191-192)**, are contained in this Court's opinion in Guice under the captions *Federal Regulation of Order Flow Payments* **(SA 184-187)** and *Preemption Analysis As Applied to Plaintiff's Common Law Agency Causes of Action.* **(SA 188-196)** In other words, the Appellate Division's comment that plaintiffs-appellants case was "similar case" to Guice was wrong. Braunstein, 657

N.Y.S.2d at 13.

b. The Mere Existence of Some Federal Regulation Permitting the Use of "Free Credit Balances" Belonging to Customers of Broker-Dealers By Broker-Dealers Does Not Evidence Intent to Preempt State Regulation of State Law Claims for Redress by Customers of Broker-Dealers For Benefits Improperly Arrogated By Broker-Dealers to Themselves From Such Use

1. New York Cases and Law

This Court recently ruled that even where a Federal Regulatory Scheme was pervasive, that scheme did not necessarily preempt state enforcement of its own laws. In the People v. Pymm, 76 N.Y.2d 511, 563 N.E.2d 1, 561 N.Y.S.2d 687 (Ct. App. 1990) the State of New York proceeded with the criminal prosecution of a mercury thermometer company and a related glass company located in the same building along with certain individual defendants for injuries to several workers, including mercury poisoning. The question presented was whether extensive Federal regulation of workplace safety under the Occupational safety and Health Act of 1970 (29 U.S.C. §651 et seq.) preempted

[p. 16]

New York's efforts to punish culpable employer conduct under its criminal laws. Accordingly, this Court ruled that there was no preemption.

> In reaching our conclusion that Federal regulation of occupational health and safety does not occupy the field, we note first that the comprehensiveness of a Federal statute or regulation does not necessarily indicate that Congress intended it to have preemptive effect. Pymm, 76 N.Y.2d at 522, 563 N.E.2d at 6, 561 N.Y.S. 2d at 692.

See also, City of New York v. Job-Lot Pushcart, 88 N.Y.2d 163, 666 N.E. 2d 537, 643 N.Y.S. 2d 944 (Ct. of Appeals 1996) (Held that New York City ordinance regulating toy guns was not preempted by the Federal Toy Gun Law); People v. Cook, 34 N.Y.2d 100, 109, 312 N.E.2d 452, 356 N.Y.S.2d 259 (Ct. App. 1974); and Monroe-Livingston Sanitary Landfill v. Town of Caledonia, 51 N.Y.2d 679, 683, 417 N.E.2d 78, 80, 435 N.Y.S.2d 966, 968 (Ct. App. 1980). This court cited as authority for its Gun Law decision the United States Supreme Court decision in Silkwood v. Kerr-McGee Corp., 464 U.S. 238, 104 S.Ct. 615, 78 L.Ed.2d 443 (1984). In Silkwood, the court considered whether the fact that the Congress had intended the Federal Government to occupy the entire field of nuclear safety meant that an Oklahoma jury was precluded from awarding punitive damages for injuries caused by exposure to radiation at the workplace. The Supreme Court noted that "even though it was aware of the NRC's exclusive authority to regulate safety matters," Congress assumed that state-law remedies were available to those individuals injured by nuclear incidents. Silkwood, 464 U.S. at 249.

No doubt there is tension between the

> conclusion that safety regulation is the exclusive concern of the federal law and the conclusion that a State may nevertheless award damages based on its own law of liability. But as we understand what was done over the years in the legislation concerning nuclear energy, Congress intended to stand by both concepts and to tolerate whatever tension there was between them. Silkwood, 464 U.S. at 256.

The plaintiffs-appellants argument is the same as Pymm, Job-Lot Pushcart

[p. 17]

and Silkwood in that even though the federal regulatory scheme relating to the securities industry is extensive, it is not preemptive of the State's authority to allow liability claims such as a breach of fiduciary duty and unjust enrichment in regard to the one-way attribution by defendants-respondents of the benefits generated from the use of free credit balances. The Appellate Division ignored this line of authority.

For a state law to fall within the "preempted" zone, it must have some direct and substantial effect on the regulated field, and this Court has so held:

> The United States Supreme Court has decreed that unless Congress manifestly and clearly intends to preempt the States' exercise of jurisdiction over matters relating to the welfare of their citizens, the States' police powers are not to be superseded by a federal act. City of

> New York v. Job-Lot Pushcart, 88 N.Y.2d 163, 166-167, 666 N.E.2d 537, 540, 643 N.Y.S.2d 944, 946 (Ct. App. 1996).

See also, Monroe-Livingston Sanitary Landfill v. Town of Caledonia, 51 N.Y.2d 679, 683, 417 N.E.2d 78, 80, 435 N.Y.S.2d 966, 968 (Ct. App. 1980) ("[w]here local government is otherwise authorized to act, it will be prohibited from legislating on a subject only if the State preempts the field through legislation evidencing a State purpose to exclude the possibility of varying local legislation.").

Such parameters have been recognized by New York courts. In Ghandour v. Shearson Lehman Hutton, Inc., 174 A.D.2d 317, 317, 570 N.Y.S.2d 541, 542 (1st Dep't), appeal dismissed, 79 N.Y.2d 823, 580 N.Y.S.2d 201 (1991), an investor brought an action alleging, inter alia, breach of fiduciary duty stemming from his commodities trading account. The court held that the Commodity Exchange Act did not preempt or abolish traditional common law claims for damages. In so holding, the court stated, "[w]e agree with the overwhelming body of case law which holds that, while establishing a wide-ranging scheme for the regulation of commodities trading, nothing in

[p. 18]

the Act preempts or abolishes traditional common law claims for damages." Id. See also Pettigrew v. Oppenheimer & Co., 582 F. Supp. 98, 100 (D. Mass. 1984) (court based its decision that Massachusetts consumer protection statute not preempted by CEA upon "consensus that the Act does not preempt state common law claims").

2. Federal Cases and Law

It has long been held that the existence of a federal regulation or statute -- no matter how comprehensive -- alone is insufficient to justify preemption of state law. English v. General Elec. Co., 496 U.S. at 87 ("Undoubtedly, every subject that merits congressional legislation is by definition, a subject of national concern. That cannot mean, however, that every federal statute ousts all related stated law...."). Accord, Cipollone v. Liggett Group, Inc., 112 S. Ct. 2608, 2618 (1992) ("That Congress requires a particular warning label does not automatically preempt a regulatory field"; holding that certain common law damages actions are not preempted by Federal Cigarette Labelling and Advertising Act); CSX Transp., Inc. v. Easterwood, 113 S. Ct. at 1739-40 (regulation adopted under Federal Railroad Safety Act, which required states to determine need for, and type of safety devices to be installed at grade crossing did not preempt state common law negligence claim regarding railroad's duty to install traffic control devices at crossings); Khalid Bin Talal Bin Abdul Azaiz Al Seoud v. E.F. Hutton & Co., 720 F. Supp. 671, 679 (N.D. Ill. 1989) ("As a general matter, the establishment of a federal regulatory scheme -- even one that comprehensively addresses an important social concern -- does not automatically preempt the applicable state common law causes of action").

At least one United States District Court has held, "Congress has legislated a great deal in the area of securities law, but the Securities Act of 1933 and the Securities

[p. 19]

Exchange Act of 1934, as well as the amendments thereto and rules promulgated thereunder, do not preempt state causes

of action in this field." Mallen v. Merrill Lynch Futures, Inc., 623 F. Supp. 203, 206 (N.D. Ga. 1985) (finding that common law fraud. negligence and breach of fiduciary duty claims were not preempted by the Commodities Exchange Act, because such would not be preempted under the Securities Acts). In federal securities fraud actions, courts consistently and regularly entertain pendant state claims.

3. Securities Exchange Commission Rules and Regulations

Importantly, the Securities Exchange Act also has "savings" clauses incorporated in section 28(a) of the Act (15 USC §78bb[a]), which provides that the Exchange Act's rights and remedies are "in addition to any and all other rights and remedies that may exist at law or in equity," and that the Act does not "affect the jurisdiction of [states] over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules or regulations thereunder." The SEC has similarly stated:

> It should be emphasized that the reserve provisions of proposed Rule 15c3... are designed exclusively to provide a means for computing and maintaining required reserves and that they would in no way purport to affect or diminish the rights of any customer under existing applicable law in his relationship with his broker-dealer with respect to his funds and securities.

Proposal to Adopt Rules 15c3-3 and 15c3-4 Under the

Securities Exchange Act of 1934 and to Amend Rules 8c-1 and 15c2-1 Under that Act, Exchange Act Release No. 34-9388, 1971 SEC LEXIS 231 at * 16-17 (Nov. 8, 1971) ("SEC Rel. No. 34-9388") (SA 91-112). The Appellate Division failed to consider the impact of this express

[p. 20]

Congressional and agency language authorizing continued state involvement on whether the savings clauses extend to cover the claims asserted by the plaintiffs-appellants.

c. Primary Jurisdiction Or Preemption Is Narrowly Employed In Cases Regarding The Fixing Or Validity Of A Commercial Rate or Tariff

The relevant cases illustrate the "relatively narrow scope of the doctrine of primary jurisdiction." Goya Foods, Inc. v. Tropicana Prod., Inc., 846 F.2d 848, 851 (2d Cir. 1988). The doctrine has been employed principally where a lawsuit raises an issue regarding the fixing or validity of a commercial rate or tariff, which are traditionally established or approved by a federal administrative body. See, e.g., Gordon v. New York Stock Exch., 422 U.S. 659 (1975) (antitrust action challenging brokers' fixed commission rates within SEC's primary jurisdiction); United States v. Western Pac. R. Co., 352 U.S. 59 (1956) (construction of tariff rates within primary jurisdiction of Interstate Commerce Commission); Far East Conf. v. United States, 342 U.S. 570 (1952) (antitrust action challenging shipping rates within primary jurisdiction of the Federal Maritime Board); National Common. Ass'n v. American Tel. & Tel. Co., 813 F. Supp.

259 (S.D.N.Y. 1993) (action challenging bill structure based upon tariffs within the primary jurisdiction of the Federal Communications Commission); Dahl v. Charles Schwab & Co., No. 93-16272 (Minn. D.C., 4th District April 7, 1994) (breach of fiduciary duty claim challenging broker's regulatory rate structure within primary jurisdiction of SEC).

VI. CONCLUSION

The Appellate Division, First Department's reversal of the Supreme Court's Order is erroneous and must be reviewed. The First Department has decided, erroneously,

[p. 21]

plaintiffs-appellants' case is a "similar case" to the order flow payments, and therefore it must be similar to Guice. Unlike order flow payments, which are extensively regulated by the SEC, the SEC has expressly refused to regulate free credit balances that occur as a result of a securities transaction.

This case presents novel issues and has enormous public policy considerations, especially for the millions of small, individual investors who will be affected by the outcome of this litigation and also presents substantial Constitutional questions. Plaintiffs-appellants ask this court for an opportunity to fully brief these and all of the issues discussed above. For the foregoing reasons, Braunstein respectfully requests that the within Motion be granted.

Dated: New York, New York, October __, 1997

Respectfully submitted,

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[p. 22]

APPENDIX L

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

DAVID J. BRAUNSTEIN and ROSEMARIE BRAUNSTEIN, JOINT TENANTS, ROYAL TOWING/FBO DAVID J. BRAUNSTEIN RETIREMENT PLAN, DAVID J. BRAUNSTEIN, TRUSTEE ROYAL TOWING, INC. PENSION PLAN, NEIL WEINER, BURTON SOLOMON, SANDRA MALLIEN, JO ANN duPONT, PHILIP KARP, ESTATE OF EDITH CAMPER, deceased, THOMAS McWHORTER, PAUL KAHN CUSTODIAN FOR THE BENEFIT OF MICHAEL KAHN, WILLIAM L. NORTON, RUDOLFO XIMENES, ROBERT SAPINZON and RUTH SAPINZON, TRUSTEES SAPINZON FAMILY TRUST, on behalf of themselves and all others similarly situated,

Plaintiffs,

vs.

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED (Merrill), PRUDENTIAL SECURITIES

INCORPORATED (Prudential), SMITH BARNEY SHEARSON INC. (Smith Barney), KEMPER SECURITIES GROUP INC. and KEMPER SECURITIES, INC. (Kemper), DEAN WITTER REYNOLDS INC. (Witter), ALEX, BROWN & SONS, INC. (Brown), BEAR, STEARNS SECURITIES CORP. (Bear Stearns), CHARLES SCHWAB & CO., INC. (Schwab), KIDDER [PEABODY AND CO. INCORPORATED (Kidder), PAINE WEBBER INCORPORATED (PW), LEHMAN BROTHERS INC. (Lehman),

Defendants.

Index No.: 94/111667

Date Purchased: 4/25/94

IAS Part: Plaintiff designates NEW YORK County as the place of trial

THE BASIS OF THE VENUE IS DEFENDANTS' PLACE OF BUSINESS

SUMMONS PLAINTIFF RESIDES AT:
102 West Butler Street
Phoenix, AX 85021-4521

BRAUNSTEIN, et al. v. MERRILL LYNCH, et al.
Index No. 94/111667

To the above named Defendants:

YOU ARE HEREBY SUMMONED to answer the complaint in this action and to serve a copy of your answer, or, if the complaint is not served with the summons, to serve a notice of appearance, on the Plaintiff's Attorney(s) within 20 days after the service of this summons, exclusive of the day of service (or within 30 days after the service is complete if this summons is not personally delivered to you within the State of New York): and in case of your failure to appear or answer, judgment will be taken against you by default for the relief demanded in the complaint.

DATED: April 25, 1994

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BRAUNSTEIN, et al. v. MERRILL LYNCH, et al.
Index No. 94/111667

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BRAUNSTEIN, et al. v. MERRILL LYNCH, et al.
Index No. 94/111667

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CLASS ACTION COMPLAINT

PLAINTIFF'S DEMAND TRIAL BY JURY

Plaintiffs for their Class Action Complaint against the Defendants complain and allege as follows:

I. NATURE OF THE CASE

1. This is a Class action brought by citizens and residents of Arizona against the Defendants (hereinafter also referred to as "broker/dealers") who are doing business throughout the United States but who have their principal or major offices and/or operations centers in the State of County of New York. This Class action seeks restitution of any gain or benefit obtained by the Defendants (or other appropriate equitable relief) and/or money damages caused by the Defendants' unlawful and unjust use of "free credit balances" belonging to the Plaintiffs and Class members. Free credit balances are defined generally as any account balances in favor of the customer of a broker/dealer which can be withdrawn by the customer at will.

2. Plaintiffs maintained investment accounts with Defendants and deposited monies or securities with these Defendants in various accounts by several means to purchase, sell, transfer, exchange or hold securities. These accounts

generated and contained free credit balances. These free credit balances were and are held and controlled by the broker/dealer with whom a given Plaintiff or Class member dealt for the account of each of the Plaintiffs and Class members. Plaintiffs are also investors who transferred their accounts (which also included free credit balances) from one broker/dealer to another for varying reasons at one time or another.

3. Defendants have unlawfully and unjustly retained and used free credit balances belonging to Plaintiffs and the respective Class members. Plaintiffs and the Class members seek (i) to recover the interest (actual or imputed) earned by the Defendants on these unlawfully and unjustly retained and used free credit balances; (ii) restitution of any gain unlawfully and unjustly obtained by the Defendants as a result of these practices; and (iii) other appropriate equitable and injunctive relief.

4. Plaintiffs seek to represent a Class of all others in the United States who are damaged by the complained of practices of the Defendants.

II. PARTIES

5. (a) Plaintiffs (residents of Arizona) have transacted business with Defendants in a manner creating free credit balances as more fully described herein and are members of the Class they seek to represent.

(b) Defendants are member firms of the New York Stock Exchange and the National Association of

Securities Dealers. Defendants have major offices and/or operations in the State and County of New York. Defendants have acted as the broker/dealer to Plaintiffs and Class members in thousands of transactions that are identifiable from Defendants' records. In that role of broker/dealer, Defendants processed and continue to process millions of dollars of transactions daily involving the purchase, sale, exchange, transfer or holding of securities as described herein. Defendants control a major portion of all security accounts in the United States and thereby have the use of a major portion of all free credit balances in the United States.

III. JURISDICTION AND VENUE

6. Defendants are licensed to do business in the State and County of New York and have substantial contacts and a presence here. The acts complained of occurred, in whole or in part, within the state or County of New York and Defendants have benefitted from their unlawful acts here by obtaining revenue from Plaintiffs and the Class members.

IV. THE PREDECESSOR ARIZONA ACTION

7. Plaintiffs filed an action against defendants in Arizona on July 12, 1993. A First Amended Complaint was filed on July 26, 1993. In that action, plaintiff sought restitution and damages for unlawful and unjust use of "free credit balances." (Superior Court of Arizona, Maricopa County, Cause No. CV 93-11503).

8. Defendants filed a Motion to Dismiss for forum non conveniens. After limited discovery and a full hearing,

the Court, in pertinent part,[1] stated:

> Whatever standard is applied in this case, the defendants have established New York to be the more appropriate forum. First, there is no or very little question that New York is an available forum. Second, an analysis of the private and public interests involved points markedly towards New York.

Thereafter, the Court went on to rule as follows:

> The court hereby stays all further proceedings to give the plaintiffs the chance to litigate this case in New York. Should the New York court impose any substantial impediment to or limitation upon that litigation which this court would not impose, this court will consider vacating the stay and denying the motion to dismiss.

V. CLASS ALLEGATIONS

9. Plaintiffs bring this action as a Class action pursuant to CPLR §§ 901-909, on behalf of a Class (the "Class") consisting of and defined as follows:

> All persons or entities who have, or have had,

---

[1] The full text of Judge Kamin's order is appended as Exhibit "A".

> accounts with one or more of the defendants in which they have had free credit balances from which the defendants have received interest or other economic benefit for which the defendants have not properly accounted to the plaintiffs. Excluded from the class are the defendants, all employees of the defendants and the members of their immediate families, the subsidiaries and affiliates of the defendants, any trusts of any entities which they control or of which they are the beneficiaries, and the heirs, successors or assigns of any of the defendants.

10. The Class members are so numerous that joinder of all members is impracticable as they are located throughout the United States. The exact number of Class members is unknown to Plaintiffs at this time and can only be ascertained through appropriate discovery, although Plaintiffs believe there are millions of Class members whose claims, when aggregated, give this Court a sufficient amount to exercise its jurisdiction. The members of the Class may be identified from records maintained by Defendants and may be notified of the pendency of this action by mail or publication, using a form of notice similar to that customarily used in class actions.

11. Plaintiffs' claims are typical of the claims of the members of the Class. Plaintiffs and all members of the Class were damaged by Defendants' wrongful conduct in that interest or economic benefit that was earned on free credit balances was wrongfully appropriated by Defendants.

Plaintiffs do not have interests which are antagonistic to or in conflict with one another or with those they seek to represent as the relief sought is the same for each Class member.

12. Plaintiffs will fairly and adequately protect the interests of the Class members and have retained counsel competent and experienced in complex class litigation whoa re ready, willing and able to undertake all professional work required as well as the financial obligations of this case.

13. A class action is superior to the other available methods for a fair and efficient adjudication of this controversy since joinder of all Class members is impracticable. As the damage suffered by some individual Class members may be relatively small, the expense and burden of individual litigation make it impracticable and unduly burdensome for the Class members, individually to redress the wrongs suffered by them at the hands of Defendants.

14. Common questions of law or fact exist as to all Class members and these common issues predominate over questions solely affecting individual Class members. Among the questions of law or fact common to the Class are:

(a) Whether Defendants participated in and pursued the common course of conduct complained of;

(b) Whether Defendants were unjustly enriched at the expense of Plaintiffs and Class members as a result of Defendants' practice of using Plaintiffs' and Class members' free credit balances thereby entitling Plaintiffs and

Class members to restitution and other appropriate relief;

(c) Whether Defendants breached their fiduciary duties to Plaintiffs and Class members by using free credit balances belonging to Plaintiffs and Class members thereby causing damage to Plaintiffs and Class members.

(d) Whether the Class members have sustained damages, and if so, the proper measure of such damages;

(e) Whether Defendants should be enjoined from continuing their improper conduct described here.

15. Defendants are the parties opposing the Class and each has acted on grounds generally applicable to the Class thereby making appropriate final legal and injunctive relief or corresponding declaratory relief with respect to the Class as a whole.

VI. ACTS UPON WHICH CLAIMS FOR RELIEF ARE BASED

16. Plaintiffs repeat and reallege each of the statements made in Paragraph numbers 1 through 14 as if fully set forth here.

17. Over the past several years, Plaintiffs and Class members were investors who have or have maintained accounts with Defendants. Plaintiffs and Class members placed funds (or securities) under the control or in the possession of Defendants thereby permitting Defendants to

engage in transactions such as the buying, selling, exchanging, transferring or safekeeping of securities. In some instances, Defendants acted as the clearing agent for other broker/dealers. By this conduct, free credit balances are created amounting to millions of dollars each day which lawfully belong in Plaintiffs' and Class members' accounts. Defendants have failed to account to Plaintiffs or Class members for their unauthorized use of these free credit balances.

18. Each Defendant has earned and continues to earn fees on the purchases, sales, exchanges, transfers and/or safekeeping of Plaintiffs' and Class members' securities.

19. Free credit balances are created in a variety of ways in Plaintiffs' and Class members' accounts, including, but not limited to: a) proceeds from the sale of securities, including money market fund liquidations; b) dividends from securities held in the account; c) interest on fixed income securities; d) deposits of cash into the account; e) distributions from mutual funds; f) withdrawals from qualified plans; and g) transfers of a customer's account between broker/dealers. These free credit balances created in Plaintiffs' and Class members' accounts are likewise used by the Defendants without authority in the operation of their businesses for their economic benefit and without accounting or benefit to the Plaintiffs and Class members.

VII. CLAIMS FOR RELIEF

COUNT I UNJUST ENRICHMENT CLAIM SEEKING

RESTITUTION OR OTHER EQUITABLE REMEDIES AS RELIEF

20. Plaintiffs repeat and reallege each of the statements in Paragraph numbers 1 through 18 as if fully set forth here.

21. Defendants were unjustly enriched to the extent of interest earned but unpaid to Plaintiffs and the Class members as well as to the extent the Defendants profited and gained from their unlawful and unjust use of Plaintiffs' and the Class members' free credit balances. Defendants publicly report that substantial percentages of their annual earnings result from interest income on free credit balances. Defendants have no legal or equitable right to profit or gain economic benefit from the use of free credit balances without compensating Plaintiffs and Class members. Plaintiffs and Class members are and were therefore damaged by these acts of Defendants.

22. Upon information and belief, Defendants loaned the unlawfully and unjustly retained free credit balances to other customers at relatively high interest rates for Defendants' benefit and profit. This method of operation and business practice by the Defendants reduces their need to borrow federal or commercial funds at going rates of interest, and, therefore, becomes a free or very inexpensive source of working capital for Defendants, enabling them, upon information and belief, to earn large returns on Plaintiffs' and Class members' free credit balances. There is no authority or legal or equitable justification for these acts and Defendants are not entitled to retain the benefits of their unlawful

conduct. Plaintiffs and the Class members have not waived any rights to interest on these free credit balances nor consented to these acts.

23. Plaintiffs and Class members are entitled to recover any unlawful gain or profit received by Defendants during the period of the unlawful or unjust use by Defendants of the free credit balances, including interest earned or other economic benefit and to have restitution thereof and other appropriate legal and equitable relief.

COUNT II: BREACH OF FIDUCIARY DUTY CLAIM SEEKING DAMAGES

24. Plaintiffs repeat and reallege each of the statements made in Paragraph numbers 1 through 22 as if fully set forth here.

25. At the time Defendants received and took control and possession of Plaintiffs' and the Class members' accounts. Defendants were or became fiduciaries and trustees with respect to those accounts and the free credit balances.

26. Defendants owed fiduciary duties to Plaintiffs and the Class members, such as loyalty, accountability, disclosure and restraint from the misuse of Plaintiffs' and Class members' free credit balances.

27. By committing the acts complained of Defendants breached their fiduciary duties to Plaintiffs and Class members.

28. Plaintiffs and the Class members were thereby damaged in that the use of their free credit balances was unlawfully and unjustly denied to them while Defendants unlawfully and unjustly profited.

WHEREFORE, Plaintiffs pray for judgment as follows:

A. Determining that this action is a proper Class Action as defined and maintainable under CPLR Article 9;

B. Against each Defendant and in favor of Plaintiffs and all Class members for damages in an amount determined by a full accounting for the use of Plaintiffs' and Class members' free credit balances; for restitution thereof and impressing a trust in the amount due the Plaintiffs and Class members;

C. For pre-judgment interest on those amounts as determined by the Court;

D. For both a temporary and permanent injunction -- enjoining Defendants from continuing the practices complained of and/or a declaratory judgment that these acts are unlawful;

E. Awarding Plaintiffs and Class members the costs of this suit, including reasonable attorneys' fees, accountants' and experts' fees and other disbursements; and

F. Ordering such other and further relief at law or equity as may be just and proper.

BRAUNSTEIN, et al. v. MERRILL LYNCH, et al.
Index No. 94/111667

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APPENDIX M

SUPREME COURT OF THE STATE OF NEW YORK
NEW YORK COUNTY: IAS COMMERCIAL PART 14

DAVID J. BRAUNSTEIN, et al.,

Plaintiffs,

v.

INDEX NUMBER
11167/94

MERRILL LYNCH, PIERCE,
FENNER & SMITH,
INCORPORATED, et al.,

Defendants.

WALTER M. SCHACKMAN, J:

This is a motion by the defendants for an order, pursuant to CPLR 3211(a) (2), (5) and (7), 3013 and 3016(b), dismissing the complaint for lack of subject matter jurisdiction, failure to comply with the applicable statute of limitations, failure to state a cause of action, and failure to plead with sufficient particularity.

I
THE FACTS

The plaintiffs are residents of the State of Arizona and

customers of the defendants, which are securities broker-dealers. The complaint seeks the return to the customers of the benefits derived by defendants from the use of customers' free credit balances. Free credit balances are liabilities of a broker-dealer which are subject to immediate cash payment to customers on demand, whether resulting from sales of securities, dividends, interest deposits or otherwise. The complaint asserts that the defendants' practice of retaining these benefits is an unjust enrichment and a breach of fiduciary duty. Plaintiffs seek to represent a class. A class certification motion has not yet been formally submitted.

Defendants argue that the complaint should be dismissed because the Commerce and Supremacy Clauses require that the issue of the payment of interest on free credit balances be left in the hands of the appropriate 'Federal regulatory authority, which, of course, is the Securities and Exchange Commission ("SEC"). Similarly, defendants urge that this case should be dismissed in deference to the SEC's primary jurisdiction. In addition, defendants contend that the complaint does not state causes of action for breach of fiduciary duty and unjust enrichment, that plaintiffs lack standing and that plaintiffs' claims are time barred.

II
DISCUSSION

On a motion to dismiss a complaint for legal insufficiency, the Court accepts the facts alleged as true and determines simply whether the facts alleged fit within any cognizable legal theory. Morone v Morone, 50 N.Y.2d 481, 485, 429 N.Y.S.2d 592 (1980).

A. The Complaint In General

In an action for restitution, a complaint is sufficient which alleges that the defendant has received from the plaintiff a sum of money that it cannot conscientiously retain. Schank v Schuchman, 212 N.Y. 352 (1914). The law will compel restitution from a person who unjustly obtains money belonging to another. Mac Murray v City of Long Beach, 292 N.Y. 286 (1944); Pink v Title Guarantee & Trust Co., 274 N.Y. 610 (1937). Here, the gist of the action is that the defendants, in receiving and unjustly retaining certain monies, committed a breach of fiduciary duty. The law recognizes a class of implied contract created by law where none in fact exists, otherwise known as constructive contract. Such a contract rests upon the equitable principle that a person shall not be allowed to enrich himself or herself unjustly at the expense of another. When others have placed money in the possession of one person under such circumstances that in equity 'that person ought not to retain it, the law implies a promise to repay. Paramount Film Distributing Corp. v State, 30 N.Y.2d 415, 334 N.Y.S.2d 388 (1972), cert. denied, 414 U.S. 829 (1973); Bradkin v Leverton, 26 N.Y.2d 192, 309 N.Y.S.2d 192 (1970); Oursler v Armstrong, 10 N.Y.2d 385, 223 N.Y.S.2d 477 (1961).

The complaint here appears to state causes of action for unjust enrichment and breach of fiduciary duty in general terms. There are, however, two concerns that are pertinent to this case. The first is whether or not the claims have been set forth with the required detail. The second is whether what possibly are otherwise valid claims are defeated, in whole or in part, by the existence of account agreements with the

broker-dealers. I will return to these points. I wish, however, to focus now on what are, as presented, defendants' major arguments.

B. Preemption and Primary Jurisdiction

I reveal no startling discovery when I say that Congress and, pursuant to the will of Congress, the SEC have respectively legislated in and regulated the securities field very extensively. On the other hand, the basic ground rules for Federal activity clearly and expressly preserve a role for the states in the securities field. Section 28(a) of the Securities Exchange Act provides:

> The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity. (15 USC § 78 bb(a))

The states have not been entirely bashful when the subject of securities is raised, as is apparent to anyone who inspects the blue skies of the various jurisdictions.

Both sides to this controversy agree that Section 28(a) needs to be factored into the decisional calculus, but that that provision cannot be the beginning and the end of analysis. The United States Constitution speaks to the question in the Supremacy Clause of Article IV and there is considerable precedent construing and applying the Clause that must be taken into account. Thus, Section 28(a) leaves the several states with the authority to regulate securities transactions that the Supremacy Clause allows. Lerov v Great Western United

Corp., 443 U.S. 173, 182 n. 13 (1979).

1. The Regulation of Free Credit Balances

Free credit balances come into being and exist for varying periods of time, sometimes only for a few hours. Such balances, as defendants put it (Mem., p. 7), are the results "of a dynamic and complex mass of large and small receipts and disbursements in hundreds, thousands or even millions of accounts."

Section 15(c)(3) of the Exchange Act directs the SEC to prescribe rules and regulations needed "to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers including ... the carrying and use of customers' deposits or credit balances." (15 U.S.C. § 78o(c) (3)) These rules and regulations must "require the maintenance of reserves with respect to customers' deposits or credit balances [and] establish minimum financial responsibility for all brokers and dealers." Clearly, the Congress was here concerned in large part with the risk to investors caused by the possible financial collapse of brokers and dealers. See SEC Exchange Act Release No. 34-9388, at 1-3 (Nov. 8, 1971). See also SEC Exchange Act Release No. 34-9622, at 3 (May 31, 1972) ("IT]he rule prohibits the utilization of customers' funds and customer derived funds in areas of the firms [sic] business such as underwriting, trading and overhead. It was too often the case, particularly during the 19681970 period, that broker-dealers expanded their trading activities and office facilities through the use of customers' funds.")

In 1972, the SEC adopted Rule' 15c3-3 to promote the protection of the integrity of customers' funds and securities as intended by Congress. Specifically, the Commission sought, among a number of things:

> (i) To insure that customers' funds held by a broker-dealer (both free credit balances and deposits which may be restricted as to withdrawal) and the cash which is realized through the lending, hypothecation and other permissible uses of customers' securities are deployed in safe areas of the broker-dealer's business related to servicing his customers, or to the extent that the funds are not deployed in these limited areas, that they be deposited in a reserve bank account. (Exchange Act Release No. 34-9856 (Nov. 13, 1972})

The SEC has recognized that traditionally broker-dealers have used their customers' free credit balances to finance customer-related activities, such as short sales and failed deliveries. Customer funds not so used must be segregated in a reserve bank account (Rule 15c3-3(e)), but the SEC has clearly allowed use of the funds to finance customer-related activities.

In In re Newman [Ann], SEC Ruling, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) § 78, 177 (Div. of Trading & Markets May 6, 1971), in response to a complaint about the practice of interest-free use of customers' free credit balances, the Commission staff noted that such balances are left as a matter of choice and convenience. The staff pointed

to the disclosure requirements of Rule 15c3-1, which seeks to ensure that the choice be informed. The staff added that "[i]n general, it may be said that the payment or the charging of interest by a broker-dealer are matters governed by contract between the parties."

In In re White, Weld & Co., 1974 SEC No-Act. LEXIS 42 (Aug. 19, 1974); White, Weld requested SEC approval for its procedures for the payment of interest on free credit balances. The staff expressed a concern about priority as to segregated funds between customers who are receiving interest and those who are not. In this discussion, it stated that "[w]e do not object to a broker-dealer paying customers interest on free credit balances . . . " In In re Monorable Frank Horton, 1983 SEC No-Act. LEXIS 2027 (March 12, 1983), in response to an inquiry whether it would be feasible to require firms to pay interest on free credit balances, the staff stated that "the Commission believes that the payment of interest on customers' free credit balances is a business matter between a broker-dealer and its customer and normally will not raise regulatory concerns."

In 1981, the Commission issued a warning to broker-dealers against misrepresenting, as part of solicitations, the availability of protection under the Securities Investor Protection Act for free credit balances maintained solely to earn interest. The Commission noted that New York Stock-Exchange Rule 436 prohibits most member organizations from paying interest on any free credit balance created for the purpose of receiving interest. The Commission stated its belief that "the payment of interest by broker-dealers on free credit balances that arise as an incidence of customer

securities activities is a business matter between a broker-dealer and its customer and normally will not raise regulatory concerns." (Exchange Act Release No. 34-18262 (Nov. 17, 1981)

As originally proposed, SEC Rule 15c3-2 would have provided that no broker or dealer shall use any free credit balances in connection with the operation of the broker or dealer's business unless procedures have been established to ensure that each customer will be informed when opening an account that he or she may request repayment, that such funds will become a part of the assets of the broker or dealer and may be used in connection with business operations "and that interest will (or will not) be paid on such funds and, if so, the rate or other basis of computation . . ." The Commission in proposing this rule noted that many customers were unaware that such balances "are not segregated and held for the customer, but rather are commingled . . . and used in the operation of the business" and that, as a result, the relationship is that of creditor and debtor. (Exchange Act Release No. 34-7266 (March 12, 1964)) In adopting the Rule, the Commission deleted the reference to disclosure as to whether interest will or will not be paid, and explained its action as follows:

> [The rule] does not specifically provide that the customer be given notice as to whether interest will or will not be paid on free credit balances because, as was pointed out by many persons who submitted comments on the original proposal, this information is not directly pertinent to the purpose of the rule,

> i.e., to put customers on notice that free credit balances left with the broker-dealer may be used in the business and therefore may be at risk. It also appeared from the comments that emphasis on this fact would introduce into the broker-customer relationship an artificial competitive factor which might lead customers to choose their brokers on the basis of this factor rather than on the basis of the kind of service to be rendered, the reliability and integrity of the firm, and other more fundamental factors which should be considered by customer in choosing a broker.

2. Preemption Principles Applied

State common law, which is what is at issue here, may be preempted. CSX Transport, Inc. v Easterwood, ___ U.S. ___, 113 S. Ct. 1732, 1737 (1993). Preemption under the Supremacy Clause may occur if Congress in a statute clearly and manifestly has indicated its purpose to achieve this result. Id. There may be preemption if Congress has implicitly revealed an intention to occupy an entire regulatory field exclusively. Freightliner Corp. v Myrick, ___ U. S. ___, 115 S. Ct. 1483, 1487 (1995). An implicit revelation of this sort may be found when Congress has legislated broadly and comprehensively. Preemption may also be found when there is an outright conflict between the Federal and the state law, when it is impossible to comply with both or "when the state law 'stands as an obstacle to the accomplishment and execution of the full purpose and objectives of Congress.'" Capital Cities Cable, Inc. v Crisp, 467 U.S. 691, 699 (1984).

See also Schneidewind v ANR pipeline Co., 485 U.S. 293, 299 (1988). Defendants argue (Reply Mem., p. 4, n. 1) that this case is one in which preemption is required because of conflict with the Federal regulatory scheme.

In addition, defendants contend that preemption is required by the Commerce Clause. This result follows when uniformity of regulation was intended and is necessary. Huron Portland Cement Co. v. Detroit, 362 U.S. 440, 444 (1960).

A number of recent cases have addressed the issue of order flow payments and Federal preemption and these are instructive. These payments are cash inducements to broker-dealers from market makers in return for routing customer orders. Order flow payments are not illegal, although the SEC is looking into the issue.

In Dahl v Charles Schwab & Co., Index No. 93-16272 (Dist. Ct., Minn., April 7, 1994), the Court noted the SEC's expertise in regard to brokerage commissions, citing Gordon v New York Stock Exchange, 422 U. S. 659 (1975). The Court found that Federal regulation permitted such payments, that the practice has a nationwide impact, that regulation is uniquely within the competence and expertise of the SEC and that state law would conflict with Federal regulation. Accordingly, preemption was found. This decision was adopted in Orman v Charles Schwab & Co., Index No. 93-CH-7365 (Cook Cry. Cir. Ct., Ill., June 2, 1994).

My colleague, Justice Shainswit, recently agreed with these decisions when the order flow practice came before her:

> A state court judicial determination that the practice of payment for order flow is a fraud on the broker's customer, and a breach of fiduciary and contract duties, would conflict directly with the SEC's tacit approval of the practice, and its determination [in a recent release seeking comments on a proposed rule] that fuller disclosure alone will likely resolve the potential for misuse of the practice. Such determination would stand as an obstacle to the SEC's accomplishment of a fairly and uniformly regulated securities industry, and so cannot be permitted." (Guice v Charles Schwab & Co., Index No. 100875/94, at 6 (Oct. 4, 1994))

The Minnesota decision was reversed on appeal in December 1994. The appellate court noted that a Federal regulation requires that a broker provide written disclosure to a customer about noncommission revenue received by the broker. This regulation addresses all noncommission revenue; none exists directed specifically to the permissibility of, or need for disclosure concerning, order flow payments. (Because SEC rule changes providing for enhanced disclosure about order flow payments was not to take effect for several months, the court expressly declined to consider the effect thereof on the preemption issue). The court found that compliance with both Minnesota law and Federal rules was not impossible since the former was more strict than the latter. The court also ruled that state common law claims based upon fiduciary duty, a duty of care and agency principles would not be in conflict with Federal law.

The court next considered whether state law would constitute an obstacle to the accomplishment of the full purpose of Congress. Insofar as plaintiffs sought added disclosure about order flow payments, that would advance a basic Federal purpose, the court concluded. And the action in other respects sought remuneration for Schwab's clients, not a prohibition against order flow payments or a determination of their illegality. Thus, the court found that plaintiffs were not endeavoring to use State law to affect the operation of the national securities markets. Dahl v Charles Schwab & Co, C1-94-1040 (Ct. Apps. Minn. Dec. 7, 1994.)

In January 1995, another Commercial Part colleague, Mr. Justice Gammerman, ruled that a state action about order flow payments was preempted by the Supremacy Clause. He contrasted Dahl with the case before him, in which the plaintiff .claimed that the payments are indeed fraudulent and illegal kickbacks, commercial bribes in violation of the Penal Law. Justice Gainmerman pointed to an SEC release in which, as he put it, the Commission "rejected the same arguments that plaintiff makes here, on the ground that they are inconsistent with the federal regulatory scheme." Evangelist v Fidelity Brokerage Services, Inc., Index No. 11150/94, at 5 (Jan. 12, 1995). In this release, the Commission recited that it had sought comment about banning of the payments or requiring broker-dealers to pass them on to the customers. The Commission had decided to reject these alternatives for several reasons. The Commission also stated that it would continue to monitor developments and "'will consider additional regulatory steps if necessary to ensure the protection of investors.'" Id.

The situation at issue in Dahl and in the cases of my colleagues in Commercial Parts 10 and 27 is distinguishable. There the SEC had examined the matter of order flow payments and whether or not those payments should be banned or the dealers required to pass on payments to customers. Insofar as a plaintiff sought the *prohibition* of such payments because of their alleged illegality under New York criminal law, that desire conflicted directly with the SEC's decision not to ban the payments. Insofar as a plaintiff might have wished to obtain %he payments on a fiduciary duty theory, that desire conflicted directly with the SEC's rejection of a requirement that the monies be passed on to customers. Furthermore, the SEC was continuing to monitor the problem to determine the need for "additional regulatory steps."

In the area of free credit balances, on the other hand, the SEC's action has been more limited. The regulatory profile sketched above shows that the SEC has recognized the practice of the use of free credit balances and has decided not to prohibit that use because such use (as limited by the SEC) is beneficial to the markets overall. But this case is about not whether customers' funds can be so used, but whether or not customers must be compensated therefor. In this area of credit balances, the SEC has focused, as it historically has, on disclosure so that customers are made aware that broker-dealers are using their funds; and the SEC has established reserve requirements that protect customers in the event of financial difficulties at the broker-dealer. These subjects too are not what concerns the plaintiffs herein. The area in which there could be a conflict of some sort between the common law and the SEC is if plaintiffs were to seek recompense for free credit balances maintained exclusively for the earning of

interest. This subject is directly regulated by Rule 436 of the Rules of the New York Stock Exchange, issued pursuant to the Federal regime for the regulation of securities. This rule has its origin in the separation between banking and the securities business, which, though perhaps not long for this new world, continues to exist. Rule 436 prohibits the payment of interest on any credit balance maintained only for the purpose of earning interest, unless banking authorities (State authorities, by the way) approve. The case at hand, it appears, does not have to do with such balances. (See Plaintiffs' Mem., p. 1, n. 1.) The balances at issue here are balances generated in connection with the carrying *out* of transactions in securities.

As to the issue of whether or not interest should be paid on free credit balances created for securities purposes, the SEC has declined to get involved. This is not a situation in which the SEC has examined the matter on the merits and declined to require that a benefit be paid because of the agency's conclusion that nonpayment of the benefit to the customer is in the best interests of the marketplace overall, as in the case of order flow payments. Here the SEC has simply taken a hands-off approach, stating repeatedly that the matter is one between customer and broker-dealer and is not of regulatory concern. See Freightliner Corp. v Myrick, supra, 115 S. Ct. at 1487. This means that the matter is left to be controlled by the law that regulates private commercial transactions, which is generally the law of contract. That law may be statutory (the UCC is an example) or it may be common law, as here. In other words, whether interest is or is not paid on free credit balances created for securities transactions does not risk a conflict with Federal regulation.

Payment of interest and compliance with SEC regulations would not be impossible nor would state common, law be an obstacle to the achievement of Federal regulatory objectives. Freightliner Corp. V Myrick, supra, 115 S. Ct. at 1487.

Disclosure requirements and rules about the maintenance of protective reserves must be uniform in a national, indeed international, marketplace such as that for securities. But, upon reflection, I do not think that a comprehensive, uniform scheme of regulation of this sort will be adversely affected at all if customer A in one state is paid interest and customer B in another is not. In a banking context, it is well known that some banking "products" provide interest and others do not, that interest may depend upon minimum balances and that there is competition for customers. None of this seems to undermine efforts to regulate the national banking system. I do not see why chaos should ensue if interest on certain balances were to be required by state common law.[1] Indeed, the White v. Weld decision suggests that there may very well be broker-dealers feverishly engaged in commerce in the Empire State which are now paying interest on all free credit balances. The regulatory world has spun on notwithstanding this cacophony. Accordingly, there is no preemption here by virtue either of the Supremacy Clause or the Commerce Clause. Basically for the same reasons, I reject the primary jurisdiction argument.

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[1] Whose state law is an issue I need not now address. I note that the parties on this motion have relied upon Federal and New York State law primarily and so I have done so as well. The named plaintiffs, however, are all Arizona residents.

C. The Adequacy of the Pleading

The mere existence of a broker-customer relationship does not give rise to a fiduciary duty. Fekety v Gruntal & Co., 191 A.D.2d 370, 595 N.Y.S.2d 190 (1st Dept. 1993). However, whenever the broker is acting as agent for the customer, such as while executing a customer's order or handling a customer's funds, there is a fiduciary duty owed to the customer. Saboundjian v Bank Audi (USA), 157 A.D.2d 278, 28'3, 556 N.Y.S.2d 258 (lst Dept. 1990); Greenwald v Shearson Lehman Brothers, Inc., N.Y.L.J., Nov. 4, 1993, p. 22, col. 3 (Sup. Ct.) (Cahn, J.); 11 N.Y. Jur. 2d, Brokers § 45. In Gilman v Merrill Lynch, Pierce, Fenner & Smith, Inc., 93 Misc. 2d 941, 944-45, 404 N.Y.S.2d 258 (Sup. Ct. 1978), a Justice of this Court wrote as follows:

> The broker, once he has received his customer's funds, is a fiduciary with respect to those funds .... After the investment is sold and funds belonging to the customer come into the broker's possession, the broker may not consciously utilize this possession to the detriment of his customer and for his own benefit. (Citations omitted.)

Normally, a customer has the right to rely upon the fact that the broker is acting for the customer's benefit at all times and the broker may not use the relationship to generate a secret profit for himself or herself. 11 N.Y. Jut..2d, supra, §§ 45, 58. However, the field has been preempted, as explained above, insofar as the permissible use of free credit balances is concerned. Brokers may use free credit balances

for their own purposes as permitted by the SEC. Rules 15c3-2, 15c3-3. As I understand it, brokers may use free credit balances in secured margin lending and failed deliveries. Plaintiffs speak of trust funds, but unlike normal trust funds, free credit balances may be used by the broker-dealers for their own purposes in the areas permitted by the SEC and this use cannot constitute a violation of a fiduciary duty. The second sentence of Gilman excerpted above therefore must be qualified. To the extent that the balances are thus used, they are not being misused; there has been no breach of trust. The question that arises, then, is whether or not plaintiffs can state, or have stated, a claim for breach of fiduciary duty under the common law because the defendants have not paid plaintiffs recompense for the permitted use of plaintiffs' funds.

In my view, plaintiffs have not set forth their claim for breach of fiduciary duty with the required particularity. CPLR 3016(b). Plaintiffs in effect have used their opposing memorandum of law in an effort to recast their pleading. This is better done by amendment that particularizes their claim. If, as appears, plaintiffs are concerned only about free credit balances created by securities transactions or plans therefor, not by depositing for the sake of interest, the pleading ought to say so.

Furthermore, the complaint is very general and contains no detailed information about the relationship between any plaintiff and any defendant. It appears that some plaintiffs dealt with some defendants, but it is not clear who deal with which entities. It appears that some plaintiffs have contracts with defendants (Mem. in Opp., p. 45, n. 32), but

the complaint alleges nothing about this. Some of the defendants, pursuant to these contracts, for all anyone knows, may have agreed to pay interest; others may have agreed to "sweep" balances into interest-bearing money market accounts on a specified schedule; others may have agreed to "sweep" accounts in other ways;[2] others may have expressly provided that interest would not be paid; and others in turn may be silent about sweeps and interest. Plaintiffs have alleged nothing about how much the balances were nor about how long the balances existed. Some statements in plaintiffs' papers suggest that the length of time a balance existed may be relevant. If a balance resulting from a transaction in stock exists only for a few minutes, the amount of time needed to crunch a few numbers and record them in a computer, then clearly there would have been no use of the funds for the benefit of defendants on which to found a claim for breach of fiduciary duty. Plaintiffs suggest that delay is an aspect of their claim, but so, it seems, is the mere use of monies for the benefit of the business of the broker-dealers; plaintiffs, in other words, do not clarify or demarcate these aspects.

Although there generally is a fiduciary duty owed by a broker when handling a customer's funds, where use of the funds for the broker's purposes is authorized by the SEC, the question becomes whether or not the dealings between the broker and the customer involved the reposing of trust or confidence by a customer in a broker. Greenwald v Shearson

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[2] The papers before the Court do not make clear the extent to which the parties are free from regulatory constraints in this regard.

Lehman Brothers, Inc., supra. Whether there was or was not a fiduciary duty and whether or not defendants have been unjustly enriched will depend upon the circumstances surrounding the relationship of the parties. See Derenco, Inc. v Benj. Franklin Federal Savings & Loan Assn., 281 Or. 533, 577 P. 2d 477, 488 (1978), cert., denied, 439 U.S. 1051 Accordingly, plaintiffs must plead their claims in greater detail.[3]

Plaintiffs in doing so, and defendants when next they move, if they do, should think about the following concerns. Unjust enrichment is another name for quasi-contract, the implication of an agreement by law in order to do equity. 22 N.Y. Jut. 2d, Contracts §§ 446-47. There can be no quasi-contract if the matter at issue is governed by an express one. See Miller v Schloss, 218 N.Y. 400, 406-08 (1916); Smith v Pagano, 154 A.D.2d 586, 546 N.Y.S.2d 415 (2d Dept. 1989), leave denied, 76 N.Y.2d 703 (1990). If, therefore, plaintiffs had account agreements that contained a provision that interest would not be paid on free credit balances, then it is hard to see how a quasi-contractual claim is available. If the

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[3] Plaintiffs should, for example, be able to state, to the best of their belief, whether or not they had formal account agreements with defendants, if so, which defendants they dealt with and what the agreements provided for with respect to free credit balances. As to plaintiffs who had no formal agreements with any defendant, they should be able to allege the defendants with which they dealt, the transactions (at least in general or by type) they engaged in with defendants and the bases upon which they so engaged. Plaintiffs should also be able to clarify exactly what they are claiming (e.g., in regard to delays).

account agreement disclosed that such balances would be used but was silent on the question of interest, the matter is more arguable but still not clear, since it can be contended that such an agreement must have been intended and understood to mean that no interest would be paid. See Derenco, Inc. v Benj. Franklin Federal Savings & Loan Assn., supra, 577 P. 2d at 556, 559, 560 (Reversed as to portion of an order awarding recovery by borrowers where agreements revealed the beneficial use of deposits and that there would be no interest. As to borrowers permitted to recover, the use of the funds did not occur *to* them and defendant did not inform borrowers of the use.) Similarly, if the SEC has authorized defendants to use the funds for their own purposes, the defendants disclose that fact in compliance with SEC rules, and account agreements expressly provide that interest will not be paid or, arguably, indicate indirectly that that is so, can defendants be held to have breached a fiduciary duty not to pay interest?[4]

For these reasons, the motion to dismiss is granted. Plaintiffs, however, have leave to replead with greater particularity, which they shall do within 30 days from service of a copy this decision and order with notice of entry.

This constitutes the decision and order this Court.

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[4] Defendants argue that the case must be dismissed on statute of limitations grounds. However, the parties agree that a four-year Arizona statute governs. (Arizona Rev. Stats. Ann. §12-550.) Thus, the action is timely as to any claims arising four years prior to commencement of this action.

DAVID J. BRAUNSTEIN, et al. v. MERRILL LYNCH, et al.
Index No. 11167/94

/s/_____
Walter M. Schackman
J.S.C.

Dated: June 7 , 1995

APPENDIX N

GREENWALD v. SHEARSON LEHMAN BROS., INC., NYLJ, NOV. 4, 1993, AT 22, COL. 3 (SUP. CT. N.Y. CO.) [SA-165-SA-166]

* * *

In New York, the relationship between a stockbroker and his or her customer is that of principal and agent and thus is considered fiduciary in nature. (Busch v. L.F. Rothschild & Co., 23 AD2d 189, 190 [1st Dept 1965]; Selcow v. Floerscheimer, 20 AD2d 889 [1st Dept 1964]; Jaksich v. Thomson Mcffinon Securities, Inc., 582 FSupp 485, 502 [SDNY 1984]). Whenever the broker is acting as the agent of the customer, for example, in executing a customer's order or handling customer funds, the customer has the right to assume and to rely on the fact that the broker is acting for his or her benefit at all times during the relationship. (Saboundjian v. Bank Audi (USA), 157 AD2d 278, 283 [1st Dept 1990]; Gilman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 93 Misc 2d 941, 944-945 [NY Sup Ct 1978]; Johnson v. Winslow, 155 Misc 170, 181 [NY Sup Ct 1935], aff'd 246 App Div 800 [1st Dept 1936], aff'd. 272 NY 467; Bosio v. Norbay Securities, Inc., 599 FSupp 1563, 1571 [EDNY 1985]). However, a fiduciary duty is not imposed on brokers in all circumstances. (See, Rolf v. Blyth, Eastman Dillon & Co., Inc., 637 F2d 7, 80-81 [2d Cir 1980]; Sherman v. Sokoloff, 570 FSupp 1266, 1269 & n. 10 [SDNY 1983]). In cases where brokers are sued for improper investment strategies, a fiduciary relationship is found only when it is apparent from the individual parties' course of dealings that

one person has reposed trust or confidence in the integrity and fidelity of the other (Selcow, 20 AD2d at 889, supra: McCollum v. Billings, 53 Misc 2d 661 [Onondaga Sup Ct 1967]).

* * *

APPENDIX O

C. SECURITIES AND COMMODITY BROKERS [§§ 45 - 81]

* * *

1. IN GENERAL [§§ 45 - 66]

§45. Generally

The relation between a stockbroker and his customer is that of principal and agent and is fiduciary in nature,[93] especially where the customer deposits money with the broker for the purchase of securities[94] or deposits securities with the broker for sale or exchange.[95] In this respect, a stockbroker has been described as a trustee.[96]

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[93] Busch v. L. F. Rothschild & Co. (1965, 1st Dept) 23 AD2d 189, 259 NYS2d 239; Selcow v Floersheimer (1964, 1st Dept) 20 AD2d 889, 248 NYS2d 934; Kennedy v Budd (1896) 5 AD 140, 39 NYS 81; People v Mercer Hicks Corp. (1956) 4 Misc 2d 55, 155 NYS2d 740, aff'd (1st Dept) 3 AD2d 708, 160 NYS2d 806; Crusius v Louchein (1928) 132 Misc 520, 230 NYS 218.

[94] Lipkien v Krinski (1920) 192 AD 257, 182 NYS 454; Haight v Haight & Freese Co. (1906) 112 AD 475, 98 NYS 471, Aff'd 190 MNY 540, 83 NE 1128.

[95] Waters v Marrin, 12 Daly 445.

[96] Kennedy v Budd (1896) 5 AD 140, 39 NYS 81; Johnson v Winslow (1935) 155 Misc 170, 279 NYS 147, Aff'd 246 AD 800, 285 NYS 1075, aff'd 272 NY 467, 3 NE2d 872, reh den 272 NY 512, 4 NE2d 423.

APPENDIX P

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

THE ESTATE OF DAVID J. BRAUNSTEIN and ROSEMARIE BRAUNSTEIN; NEIL WEINER; BURTON SOLOMON; SANDRA MALLIEN; JOANN duPONT; PHILIP KARP; CAROLYN GOODWIN as executrix of the ESTATE OF EDITH CAMPER deceased : THOMAS McWHORTER; WILLIAM L. NORTON; RUDOLFO XIMENES; AND ROBERT SAPINZON and RUTH SAPINZON, TRUSTEES SAPINZON FAMILY TRUST, on behalf of themselves and all others similarly situated,

Plaintiffs,

vs.

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED (Merrill), PRUDENTIAL SECURITIES INCORPORATED (Prudential), SMITH BARNEY SHEARSON INC. (Smith Barney), KEMPER SECURITIES GROUP INC. and KEMPER SECURITIES, INC. (Kemper), DEAN WITTER REYNOLDS INC. (Witter), ALEX, BROWN & SONS, INC. (Brown), BEAR, STEARNS SECURITIES CORP. (Bear Stearns), CHARLES SCHWAB & CO., INC. (Schwab), KIDDER PEABODY AND CO. INCORPORATED (Kidder), PAINE WEBBER INCORPORATED (PW), LEHMAN BROTHERS, INC. (Lehman),

Defendants.

NOTICE OF APPEAL

Appeal Nos. 60355, 60356

New York County Clerk's
Index No. 111667/94

SIRS:

PLEASE TAKE NOTICE that the above-named Plaintiffs, pursuant to CPLR 5601(b)(1), hereby appeal to the Court of Appeals from an order of the Appellate Division, First Department, entered in the office of the Clerk of the Appellate Division on April 24, 1997, which order unanimously reversed the Order of the Supreme Court of New York County entered in the office of the Clerk of New York County on May 10, 1996, and unanimously dismissed the appeal from the order of the same court and Justice entered on or about June 7, 1995, and which order finally determines this action where there is directly involved the construction of the provision of Article VI, clause 2 of the United States Constitution, and Plaintiff appeals from each and every part of that order of the Appellate Division as well as from the whole thereof.

Dated: New York, New York
May 27, 1997

LAW OFFICES OF MATTHEW
S. DONTZIN
885 Third Avenue, 30th Floor
New York, New York 10022
(212) 593-3014

Attorneys for Plaintiffs-Appellants

TO: BROWN & WOOD
One World Trade Center
New York, New York 10048
(212) 839-5300

Attorneys for Defendants

APPENDIX Q

STATE OF NEW YORK
COURT OF APPEALS

Stuart M. Cohen
Clerk of the Court

Clerk's Office
Albany, New York 12207-1095

May 30, 1997

Law Offices of Matthew S. Dontzin
885 Third Avenue, 30th Floor
New York, New York 10022

RE: Estate of Braunstein, et al. v. Merrill Lynch, Pierce Fenner & Smith

Dear Mr. Dontzin:

The Court has received your 5002. jurisdictional statement and may examine its subject matter jurisdiction sua sponte with respect to whether a substantial constitutional question is directly involved to support an appeal as of right.

This communication is without prejudice to any motion any party may wish to make. If you conclude that the order is not appealable as of right, please arrange for the execution of a stipulation consenting to a dismissal of the appeal and transmit that paper to my office. If a stipulation is to be forthcoming, please inform me immediately.

On the other hand, if you wish to persevere in the

appeal, you are invited to present to the Court in writing within ten days of this letter's date your comments justifying the retention of subject matter jurisdiction, including references to the record demonstrating that a constitutional question was raised in the court or other forum of original instance. Also please enclose a copy of each brief filed in the Appellate Division, as well as a copy of the Record on Appeal or Appendix filed in that court. Your adversary is likewise afforded the opportunity to comment in writing on the subject matter jurisdiction.

If this sua sponte inquiry is terminated by the Court, the Clerk will notify counsel in writing and set a new schedule for normal perfecting of the appeal.

Very truly yours,

/s/_____
Stuart M. Cohen

SMC:mec
cc: Brown & Wood

APPENDIX R

June 10, 1997

State of New York,
Court of Appeals
Clerk's Office
Albany, New York 12207-1095

attention: Stuart M. Cohen, Clerk of the Court

RE: Estate of Braunstein et al. v. Merrill Lynch, Pierce Fenner & Smith, Inc. et. al., Index No. 111667/94

Dear Mr. Cohen:

I am co-counsel with Matthew Dontzin (and a member of the New York Bar). This letter is the appellants' response to your letter dated May 30, 1997 concerning the sua sponte examination of the subject matter jurisdiction in the above referenced matter.(Your letter was received in the office of Matthew Dontzin on Monday, June 2, 1997. Plaintiffs' counsel were advised by the clerk's office that this response was due 10 days from the date of our receipt of the letter.)

CPLR § 5601. (b) (1) provides for an appeal to the court of appeals as of right on constitutional grounds "1. from an order of the appellate division which finally determines an action where there is directly involved the construction of the constitution of the state or of the United States ..." These conditions have been met as follows:

Letter, dated June 10, 1997, to Court of Appeals

1. The decision of the Appellate Division held "Under the Supremacy Clause of the United States Constitution (art VI, cl 2) plaintiffs' (common law) claims are preempted by federal law" (page 2). The decision also referred to a "similar case" in the Court of Appeals where it was held "that such common law claims (concerning order flow payments) are preempted by the 1975 amendments to the Securities Exchange Act and implementing SEC regulations (Guice v. Charles Schwab, 89 NY2d 31,39, cert denied 1997 US Lexis 1683)"

2. The decision of the Appellate Division "finally determined the action" when it stated "The Clerk is directed to enter judgment in favor of the defendant-appellants dismissing the amended complaint"(page 1).

3. The Brief of Defendants-Appellants had its primary focus on the argument "Application of State Law would Violate The Supremacy Clause Of The United States Constitution" (page 17) In support of this argument the brief states

> "The Supremacy Clause preempts plaintiffs' state law causes of action because they would conflict with the federal regulation of broker-dealer activities in connection with customer free credit balances. See U.S. Const. art.VI, cl.2."

4. In the Brief for Plaintiffs-Respondents, the Defendants' arguments concerning the Supremacy clause were comprehensively answered starting at page 8 "The Supremacy Clause Does Not Preempt Plaintiffs-Respondents Common-

Law Claims" through page 40.

5. In their Reply Brief Defendants-Appellants re stated their argument "The Supremacy Clause Preempts Plaintiffs' State Law Causes of Action" at pages 7 through 16.

> (The foregoing five points set forth the response to your letter seeking "references to the record demonstrating that a constitutional question was raised (in the Appellate Division)")

6. The essence of the Amended Complaint in this case, the allegations of which must be deemed proven for the purpose of a motion to dismiss, is that the Defendants manipulate their customer accounts to maximize the "float" period during which time Defendants use their customer's funds (described as "free credit balances"), to their unjust enrichment and in violation of their fiduciary duties.

The defendants claim that there is a "federal regulatory scheme" which permits their practices with respect to their use of "free credit balances." They claim that the Securities Exchange Act and Regulations promulgated thereunder preempt state common law under the Supremacy Clause of the United States Constitution.

This argument was rejected in the Supreme Court (Shackman,J.). The Supreme Court was then reversed by Order of the Appellate Division specifically and solely on the ground that the common law claims of the Plaintiffs were preempted by the Supremacy Clause of the United States Constitution.

For all of the foregoing reasons we believe that the Court retains jurisdiction in accordance with CPLR § 5601. (b) (1).

Pursuant to your request we enclose the Brief for Defendants-Appellants, Brief of Plaintiffs-Respondents, Reply Brief for Defendants-Appellants, the Record on Appeal and the Supplemental Joint Appendix from the Appellate Division.

After the above was written we received the undated somewhat unusual response of the defendants to the inquiry In that response the defendants have assumed that a constitutional issue exists. With this we agree. But the Defendants go beyond the scope of the inquiry and seek dismissal of the appeal on the erroneous claim that the constitutional issues in this case have been decided by this Court in *Guice* (Guice v. Charles Schwab, 89 NY2d 31, cert denied 1997 US Lexis 1683). With this we disagree.

In reversing the Appellate Division in *Guice* this court held that plaintiffs common law claims based solely on inadequate or absent disclosure of receipt of order flow payments are pre-empted by the 1975 amendments to the Securities Exchange Act and implementing SEC regulations. The Court found that the SEC has conducted an extensive inquiry into the matter and promulgated rules specifically dealing with the practice complained of and that even though New York law would support plaintiffs common law claims of inadequate or absent disclosure, such claims were preempted by SEC regulations dealing specifically with the disclosure required.

Unlike *Guice*, in this case plaintiffs do not seek to change

or avoid any SEC regulation. The SEC has not promulgated any regulation addressing the question of compensation to customers for use of their funds (free credit balances) by a broker-dealer. On the contrary, the SEC has repeatedly stated that the question of payment for use of customer free credit balances "is not of regulatory concern". (Notice to Broker-Dealers Concerning Interest-Bearing Free Credit Balances, Exchange Act Release No.18262, 4 Fed. Sec. L.Rep [CCH]§25,134B, at 18,327 (Nov.17, 1981) ("SEC Rel No.34-18262); (In Re Newman [Ann], SEC Ruling [1970-7 Transfer Binder] Fed. Sec. L. Rep [CCH] 278,177, at 80,454 [Div. of Trading and Markets May 6. 1971]). As the trial court (Shackman, J) found in the order dated June 7, 1995 (Record on Appeal in the Appellate Division page 23) "This is not a situation in which the SEC has examined the matter on the merits and declined to require that a benefit be paid because of the agency's conclusion that nonpayment of the benefit to the customer is in the best interests of the marketplace overall, as in the case of order flow payments. Here the SEC has simply taken a hands-off approach, stating repeatedly that the matter is one between the customer and broker-dealer and not of regulatory concern." For additional discussion see Brief for Plaintiffs-Respondents pages 38 to 40.

Because of the substantial factual differences between this case and *Guice* the Court of Appeals needs to review the constitutional issues involved to see if, as Plaintiffs claim, error was made in the Appellate Division when it held plaintiffs common law claims were pre-empted based upon the holding in *Guice*.

Letter, dated June 10, 1997, to Court of Appeals

Begam Lewis Marks & Wolfe

by Frank Lewis

cc: A. Robert Pietrzak

APPENDIX S

NOTICE TO BROKER-DEALERS CONCERNING INTEREST-BEARING FREE CREDIT BALANCES, EXCHANGE ACT RELEASE NO. 18262, 4 FED. SEC. L. REP. (CCH) ¶25,134B (NOV. 17, 1981) [SA-58–SA-61]

Financial Responsibility–§ 15(c) 18,327-3

* * *

[¶25,134B] Notice to Broker-Dealers Concerning Interest-Bearing Free Credit Balances

Release No. 34-18262, Securities Protection Act Release No. 100, November 17, 1981, 46 F.R. –

17 CFR 241.18262. ACTION: Notice to Broker-Dealers Concerning Interest-Bearing Free Credit Balances.

SUMMARY: The Securities and Exchange Commission today cautioned broker-dealers against soliciting customers to deposit or leave funds with a broker-dealer for the purpose of creating or maintaining cash balances solely to earn interest. The Securities Investor Protection Act of 1970 protects "customer" claims up to $500,000 per customer, no more than $100,000 of which can be claims for cash. Protection under that Act is available for a cash balance, however, only if that balance is in an account for the purpose of purchasing securities or as a result of a sale of securities. Cash balances created or maintained solely for the purpose of earning interest are not protected under that Act. Therefore,

misrepresentations by broker-dealers about the availability of protection under that Act and other misleading broker-dealer advertising, promotional or selling practices that could result in a denial of "customer" status and thus protection under that Act –because such practices, among other things, induce investors to deposit or leave funds with a broker-dealer solely for the purpose of earning interest–will be deemed violations of the rules of the self-regulatory organizations and the Commission. Advertisements that misrepresent the availability of protection under the Securities Investor Protection Act of 1970 also will be deemed violations of Section 15(d) of that Act.

DATE: November 17, 1981

* * *

SUPPLEMENTARY INFORMATION: Some broker-dealers currently state, in oral communications and in written advertisements, that they pay interest on customers' free credit balances.[1] The Commission believes that the payment

---

[1] Free credit balances are customers' funds held by broker-dealers that may be withdrawn by customers on demand. Usually, they are generated when (i) a customer gives cash to the broker-dealer with advice that instructions for the purchase of securities will follows; (ii) a broker-dealer receives interest or dividends on the customer's securities held in "street" name and does not immediately transmit those funds to the customer; or (iii) a broker-dealer sells a customer's securities and holds the proceeds pending reinvestment or other instruction from the customer. *See* SEC, Report of the Special Study of the Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 1, ch. III, at 393-94 (1963). Free credit balances are liabilities owed by the broker-dealer to the customer. *See* 17 CFR § 240.15c3-3(a)(8).

of interest by broker-dealers on free credit balances that arise as an incidence of customer securities activities is a business matter between a broker-dealer and its customer and normally will not raise regulatory concerns.[2] When broker-dealers engage in certain advertising, promotional or selling practices to obtain these funds, however, those practices may constitute violations of the Securities Investor Protection Act of 1970 ("SIPA") and the rules of self-regulatory organizations ("SRO's") and the Commission.

* * *

---

[2] The Commission also believes, however, that there may be a regulatory distinction, for purposes of application of the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940, between the conventional type of interest-bearing free credit balance that arises as an incidence of maintaining a securities account for a customer and an interest-bearing account that is, in economic reality, a separate security.

APPENDIX T

IN RE NEWMAN (ANN), SEC RULING [1970-71 TRANSFER BINDER] FED. SEC. L. REP. (CCH) ¶ 78,177 (DIV OF TRADING AND MARKETS MAY 6, 1971) [SA-116–SA-117]

[SA-116]

Number 382–115 New SEC Rulings 80,545
8-11-71 *Newman (Ann)*

* * *

[¶78,177] Newman (Ann).

Securities and Exchange Commission, Division of Trading and Markets. May 6, 1971. Correspondence in full text.

Exchange Act–Broker-Dealer–Use of Free Credit Balances and Charging Interest on Borrowed Funds.–The extent to which a broker-dealer's use of free credit balances without interest is governed by Rules 15c3-1 and 15c3-2 is discussed. The extent to which a broker-dealer may charge interest on loans to customers, as governed by contract provisions and Rule 10b-16, is also discussed.

See ¶22,736, "Exchange Act–Manipulations" division; and ¶25,126 and 25,127, "Exchange Act–Over-the-Counter Markets" division, Volume 2.

[SEC *Staff Reply*]

Dear Mrs. Newman:

In your letter dated April 25, 1971, you are critical of some broker-dealers who will not pay interest on the "free funds" of customers, but who charge interest on the money customers owe them.

By "free funds", I assume you refer to "free credit balances." As seen from the attached copy of Securities Exchange Act Release No. 7325 [see ¶77,000] in which the Commission announced the adoption of Rule 15c3-2 under that Act, free credit balances are "funds which the customer has an unrestricted right to withdraw." Thus, when a customer leaves his free funds with his broker-dealer, he does so as a matter of choice and convenience. In order that customers should be made aware of this, Rule 15c3-1 specifically provides that a broker-dealer must give periodic notice to that effect (not less than quarterly) to customers who have free credit balances, while reminding such customers that, with respect to those free funds they do not withdraw, the broker-dealer might use them in his business.

With regard to the charging of interest on amounts which customers owe him (debit balances), the broker-dealer will, in general, have to borrow comparable amounts from banks on interest bearing obligations. In the usual form of "customers' agreement" there is a provision for the charging of interest on debit balances of the customer at a rate

related to "money market conditions." The Commission's Rule 10b-16 under the Securities Exchange Act of 1934 provides for initial and periodic information to customers of the bases on which he charges them interest. A copy of Rule 10b-16 is included in the enclosed copy of Securities Exchange Act Release No. 8773 [scc ¶77,765].

In general, it may be said that the payment or the sharing of interest by a broker-dealer are matters governed by contract between the parties.

I trust that this satisfactorily explains the matters about which you have expressed concern.

Sincerely,

Federal Securities Law Reports ¶78,177

[SA-117]

80,546 Number 352–116
8-11-71

[Letter of Inquiry]

Dear Sir:

The purpose of this letter is to file a vigorous complaint against the practice of allowing stock brokerage firms to use customers' free funds without paying any interest for such use. It is incredible, especially in these times, that a brokerage firm is able

to use a customers' free funds for unlimited periods of time and not be required to pay even one cent of interest. And to add insult to injury, the brokerage firm turns right around and charges the customer the highest possible rate of interest for even a single day's overdue payment.

In conclusion, money is far too expensive to allow anyone its free use, certainly not a sector of private enterprise which is supposed to be regulated by a government agency in the public interest.

Very sincerely yours,

* * *

APPENDIX U

SECURITIES ACT OF 1933

Act of May 27, 1933; 48 Stat. 74; 15 U.S. Code, Secs. 77a-77aa, as amended.

An Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

[¶501] SHORT TITLE

Sec. 1. This title may be cited as the "Securities Act of 1933."

* * *

[¶721] ADDITIONAL REMEDIES

Sec. 16. The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity.

* * *

[¶751] STATE CONTROL OF SECURITIES

Sec. 18. Nothing in this title shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person.

APPENDIX V

SA-91

PROPOSAL TO ADOPT RULE 15C3-3, EXCHANGE ACT RELEASE NO. 9388, 1971 WL 16389 (NOV. 8, 1971) [SA-91–SA-112]

Release No. 34-9388
(Cite as: 1971 WL 16389 (S.E.C.))

Securities and Exchange Commission (S.E.C.)
*1 Securities Exchange Act of 1934

November 8, 1971

PROPOSAL TO ADOPT RULES 15c3-3 AND 15c3-4 UNDER THE SECURITIES EXCHANGE ACT OF 1934 AND TO AMEND RULES 8c-1 AND 15c2-1 UNDER THAT ACT

Notice is hereby given that the Securities and Exchange Commission had under consideration a proposal to adopt Rules 15c3-3 and 15c3-4 under the Securities Exchange Act of 1934 ("the Exchange Act"), and to amend Rules 8c-1 and 15c2-1 thereunder, to provide for reserves and related measures respecting the financial responsibility of brokers and dealers in the public interest and for the protection of investors. The proposed rules and amendments are designed to implement the provisions of Section 15(c)(3) of the Exchange Act which were added by Section 7(d) of the Securities Investor Protection Act of 1970 ("the SIPC Act").

[FN1] The proposed rules and amendments would be adopted under Sections 8(b), 8(c), 10(b), 15(c)(2), 15(c)(3), and 23(a) of the Exchange Act, as well as under Sections 6(c)(2)(C)(iii) and 67(c)(2)(B) of the SIPC Act.

Purpose of Proposed Rules and Amendments

The SIPC Act which affords specified protection to customers of brokers and dealers, [FN2] also provides for backstop financing under certain contingencies by the Securities and Exchange Commission and the Secretary of the Treasury, to a maximum amount of one billion dollars. [FN3] In that context, Congress was manifestly concerned that there be no recurrence of the unsafe and unsound practices in the industry which had placed securities and funds of customers in jeopardy and which prompted Congress to pass this legislation. Accordingly, in addition to directing the Commission to conduct a thorough study of such practices and to report on measures taken and recommended for their elimination, [FN4] Congress amended Section 15(c)(3) of the Exchange Act to clothe the Commission with the authority to adopt rules providing for safeguards respecting the financial responsibility of brokers and dealers concerning the acceptance of custody and use of customers' securities and the carrying and use of customers' deposits or credit balances; and, in that connection, to require the maintenance of reserves. [FN5]

Upon the passage of the SIPC Act, the staff of the Commission began immediately to explore various possible methods, for safeguarding the handling of customer property and for the establishment by the industry of reserves which would be amply protective of customers' funds and securities. In addition to evaluation of various methods proposed by the

staff of the Commission, consideration of numerous proposals from other sources was undertaken. Each approach was weighed in terms of the extent to which it maximized investor protection in relation to its operational and economic impact upon the industry. From all of these expressions, the Commission has been able to evolve what it believes to be a program designed to accomplish the basic statutory objectives.

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***2** The proposed provisions for reserves are the subject of two separate proposed rules, Rules 15c3-3 and 15c3-4. Proposed Rule 15c3-3 requires the complete separation of customer funds from firm funds and provides for reserves designed to protect customer funds held by broker-dealers. Proposed Rule 15c3-4, concerned with customer protection in the area of custody and use of customers' securities, requires that the broker-dealer promptly obtain physical possession or control of customer securities and contains provisions for reserves against securities of customers which should be but are not in the physical possession or control of a broker-dealer.

* * *

Proposed Rule 15c3-3

Generally stated, proposed Rule 15c3-3 contains these basic provisions. First, there would be a requirement on the part of broker-dealers to maintain a "Special Account for the Exclusive Benefit of Customers" ("the Special Account") in the nature of a trust fund through which a broker-dealer must effectuate all transactions with regard to all "funds carried for

the account of any customer" (defined to include free credit balances, other credit balances and all deposits of customers on open transactions), as well as all cash proceeds of loans collateralized by securities carried for the accounts of customers and all cash remittances received by the broker-dealer from or on behalf of customers for any purpose whatsoever. Under the proposed rule, the broker-dealer may make withdrawals from the Special Account only for limited specified purposes, including the payment of obligations to customers, the settlement of transactions for and with customers, the depositing of cash with third persons from whom the broker or dealer has borrowed securities to make deliveries on behalf of customers, and the reimbursement to the broker-dealer for monies loaned to customers, for disbursements made on behalf of customers, for commissions, interests and other lawful charges to customers.

The operative features of the Special Account are designed to protect the integrity of customer-generated funds by insulating them against inroads from the broker-dealer's firm activities, whether they be underwriting, market overhead or of any other nature whatever. The Special Account, therefore, should achieve a virtual 100% protection to customers with respect to "the carrying and use of customers' deposits or credit balances", which is mandated by Section 7(d) of the SIPC Act. As additional protection, and in compliance with the objectives of that section for the establishment of reserves, proposed Rule 15c3-3 also provides in substance that, if there is any excess of the cash or cash equivalent accountabilities of a broker-dealer to his customers over specified accountabilies of customers to the broker-dealer, the broker-dealer shall deposit such excess in a "Cash Reserve Bank Account", such excess to be maintained at all

times on such deposit. Computations to determine whether or not such excess exists would be required to be made on a daily basis at the opening of business with respect to the transactions of the previous business day; or, in the alternative, on a monthly basis. In the latter case, the deposit to be maintained would have to be 105% of the excess. The deposit may consist of any combination of cash and specified kinds of securities issued or guaranteed by the United States.

*3 The net effect of the Special Account and Cash Reserve Bank Account requirements should be that, in no event, would customer credits and related cash accountabilities be able to be used to finance the obligations of a broker-dealer other than for the bona fide obligations of customers.

Also, as integral element in proposed Rule 15c3-3 is a provisions which would require a broker-dealer to establish and follow procedures and a system for following such procedures to verify and reconcile each of his bank statements within two weeks after he receives it from his bank.

Proposed Rule 15c3-4

On the subject of the acceptance of custody and use by a broker-dealer of the securities of customers, proposed rule 15c3-4 provides in substance that, as to fully paid and excess margin securities of customers left with the broker-dealer, such securities shall be in the physical possession or control of the broker-dealer; and it further provides that in the event of his inability to reduce them to such physical possession or control, he shall make and maintain on deposit an appropriate sum in a "Securities Reserve Bank Account" from which he may make withdrawal only to the extent, that he reduces such

securities to his physical possession on control. Moreover, in any transaction with or for a customer, to whom a broker-dealer sells a security to or purchase a security for a customer who has made full payment therefor, the broker-dealer would have to deposit the contract price in the Securities Reserve Bank Account if the broker-dealer is unable to reduce the security to his physical possession or control. If a broker-dealer as agent, for a customer, has purchased a security from another broker-dealer and, not having received timely delivery, enters the transaction on his books and records as a fail to receive, such purchasing broker-dealer would be required to make the deposit in the Securities Reserve Bank Account not later than five business days after settlement date. In the interim of course, the funds paid by the customer are required to be deposited in the Special Account provided for by proposed Rule 15c3-3.

* * *

*4 The deposits in the Securities Reserve Bank Account may consist of any combination of cash and specified kinds of securities issued or guaranteed by the United States.

* * *

Specifically Identifiable Property of Cash Customers

Both Rules 15c3-3 and 15c3-4 contain provisions to the effect that the Special Account, Cash Reserve Bank Account, Securities Reserve Bank Account, and fully paid and excess margin securities held in accordance with Rule 15c3-4 shall constitute specifically identifiable property of the customers whose interests therein are reflected on the broker-

dealers' books and records and that such customers shall be deemed cash customers within the meaning of the SIPC Act. Securities appropriated to customers on the books and records of a broker-dealer which are in his possession are similarly designated as specifically identifiable property of those customers.

* * *

Effect of Proposed Rules

***6** The purpose behind the proposed rules is to afford as complete protection as possible to customers by the establishment of reserve requirements and otherwise with respect to their funds and securities in accordance with the intent of Congress, without depriving the industry of necessary and legitimate means to carry on customer oriented business. Without freezing the liquid resources of the industry to a point at which it would no longer be viable, the proposed rules seek to accomplish virtually complete customer protection by providing the mechanisms through the medium of the Special Account and the Cash Reserve and Securities Reserve Accounts to give full effect to the obligations of broker-dealers to customers respecting their cash and securities. . . . It should be emphasized that the reserve provisions of proposed Rules 15c3-3 and 15c3-4 are designed exclusively to provide a means for computing and maintaining required reserves and that they would in no way purport to affect or diminish the rights of any customer under existing applicable law in his relationships with his broker-dealer with respect to his funds and securities.

* * *

1971 WL 16389 (S.E.C.)

PROPOSED RULE 15c3-3

Rule 15c3-3. Customer Protection Accounts - Cash.

(a) It shall be unlawful for any broker or dealer to accept or use any funds carried for the account of customers or to accept or use funds generated from the lending, hypothecation or other use of securities carried for the account of customers, except as provided for in this rule.

* * *

APPENDIX W

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APPENDIX X

NYSE RULE 436, 2 NYSE GUIDE (CCH) ¶2436 (1996)[SA-126–SA-127]]

3776 Rules of Board–Miscellaneous Rules and Provisions

* * *

Amendments.
April 21, 1966.
December 19, 1968.
March 26, 1970.
December 11, 1975; effective March 12, 1976.

¶2436 Interest on Credit Balances

Rule 436. No member organization, unless subject to supervision by State banking authorities, shall pay interest on any credit balance created for the purpose of receiving interest thereon.

* * *

APPENDIX Y

FORM BD UNIFORM APPLICATION FOR BROKER-DEALER REGISTRATION

Date: APR 26, 1993 SEC File No: 7221
CRD No: 007691

WARNING: INTENTIONAL MISSTATEMENTS OR OMISSIONS OF FACTS MAY CONSTITUTE CRIMINAL VIOLATIONS

1. Exact name and mailing address of applicant:
A. Merrill Lynch, Pierce, Fenner & Smith, Inc.
B. RS Emp. Cert. No.:
13-5674085

* * *

EXECUTION:

APR 26 1993 Merrill Lynch, Pierce, Fenner & Smith, Inc.
Date Name of Applicant

APR 26 1993 Merrill Lynch, Pierce, Fenner & Smith Inc.
Date Name of Applicant

By:/s/_____ Marie Montagnino, Vice President
Signature and Title Print Name

FINANCIAL AND OPERATIONAL COMBINED
UNIFORM SINGLE REPORT
PART II

BROKER OR DEALER

MERRILL LYNCH, PIERCE, FENNER & SMITH INC.
as of 03/26/93

COMPUTATION FOR DETERMINATION OF
RESERVE REQUIREMENTS FOR BROKER-DEALERS
UNDER RULE 15c3-3

CREDIT BALANCES

1. Free credit balances and other credit balances in customers' security accounts (see Note _, Exhibit A, Rule 15c3-3) $7,721,725,582

* * *

APPENDIX Z

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM X-17A-5

FOCUS REPORT
(Financial and Operational Combined Uniform Single Report)
PART II

This report is being filed pursuant to (Check Applicable Block(s)):

1) Rule 17a-5(a) 16 2) Rule 17a-5(b) 17

3) Rule 17a-11 18

4) Special request by designated examining authority 19

5) Other 26

NAME OF BROKER-DEALER 13 SEC FILE NO. 14

ADDRESS OF PRINCIPAL PLACE OF BUSINESS (No P.O. Box) 20 FIRM ID NO. 15

EXECUTION:

The registrant/broker or dealer submitting this Form and its attachments and the person(s) by whom it is executed represent hereby that all information contained therein is true, correct and complete. It is understood that all required items, statements, and schedules are considered integral parts of this form and that the submission of any amendment represents that all unamended items, statements and schedules remain true, correct and complete as previously submitted.

ATTENTION – Intentional misstatements or omissions of facts constitute Federal Criminal Violations. (See 18 U.S.C. 1001 and 15 U.S.C. 78:f(a))

FINANCIAL AND OPERATIONAL COMBINED
UNIFORM SINGLE REPORT
PART II

BROKER OR DEALER as of

STATEMENT OF FINANCIAL CONDITION
LIABILITIES AND OWNERSHIP EQUITY

* * *

20. Payable to customers:			
A. Securities accounts-including free credits			
of..$	950	1120	1580

APPENDIX AA

NYSE RULE 421, 2 NYSE GUIDE (CCH) ¶2421 (1996) [SA-124–SA-125]

Rules of Board–Financial Statements and Reports

Administered by Member Firm Regulatory Services

Rule 421. Member organizations and individual *direct clearing* members shall submit, as required by the Exchange, periodic reports with respect to:

(1) Short positions in securities;
(2) Customers' debit and credit balances.

Amendments.

April 4, 1968
October 7, 1982

Supplementary Material:

* * *

Amendment.
March 30, 1993.

.40 **Customers' debit and credit balances** (Form R-1).–Member organizations carrying margin accounts for customers, unless specifically exempted by the Exchange, are required to submit Form R-1 on a settlement basis, preferably as of the last business day of the month (but in any event not

earlier than the last Thursday of the month). Form R-1 specifies the following information applicable to public customers:

* * *

(4) Total of all free credit balances in cash accounts.

(5) Total of all free credit balances in all margin accounts.

Include only free credit balances in cash and margin accounts. Balances in short accounts and in Special Miscellaneous Accounts are not to be considered as free credit balances.

* * *

Each member organization carrying margin accounts for customers, unless specifically exempted by the Exchange, is required to submit a report each month. When a member organization has no information to submit, a report should be filed with a notation thereon to that effect.

Reports are due as promptly as possible after each firm's last business day of the month, but not later than the sixth day of the following month. All inquiries concerning this report should be made to the Exchange at 656-5050.

* * *

APPENDIX BB

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

DAVID J. BRAUNSTEIN and ROSEMARIE BRAUNSTEIN, JOINT TENANTS, ROYAL TOWING/FBO DAVID J. BRAUNSTEIN RETIREMENT PLAN, DAVID J. BRAUNSTEIN, TRUSTEE ROYAL TOWING, INC. PENSION PLAN, NEIL WEINER, BURTON SOLOMON, SANDRA MALLIEN, JO ANN duPONT, PHILIP KARP, ESTATE OF EDITH CAMPER, deceased, THOMAS McWHORTER, PAUL KAHN CUSTODIAN FOR THE BENEFIT OF MICHAEL KAHN, WILLIAM L. NORTON, RUDOLFO XIMENES, ROBERT SAPINZON and RUTH SAPINZON, TRUSTEES SAPINZON FAMILY TRUST, on behalf of themselves and all others similarly situated,

Plaintiffs,

vs.

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED (Merrill), PRUDENTIAL SECURITIES

INCORPORATED (Prudential), SMITH BARNEY SHEARSON INC. (Smith Barney), KEMPER SECURITIES GROUP INC. and KEMPER SECURITIES, INC. (Kemper), DEAN WITTER REYNOLDS INC. (Witter), ALEX, BROWN & SONS, INC. (Brown), BEAR, STEARNS SECURITIES CORP. (Bear Stearns), CHARLES SCHWAB & CO., INC. (Schwab), KIDDER [PEABODY AND CO. INCORPORATED (Kidder), PAINE WEBBER INCORPORATED (PW), LEHMAN BROTHERS INC. (Lehman),

Defendants.

Index No.: 94/111667

MEMORANDUM OF LAW IN OPPOSITION TO PLAINTIFFS' MOTION FOR CLASS CERTIFICATION

BROWN & WOOD
One World Trade Center
New York, N.Y. 10048
(212) 839-5300
Attorneys for Defendants

OF COUNSEL:

A. Robert Pietrzak, Esq.
Joseph McLaughlin, Esq.

* * *

It cannot be presumed that potential class members did not consent to their brokers retaining the benefits earned on the use of free credit balances. To the contrary, consent should be presumed, in the absence of evidence to the contrary, because the long-standing industry practice was not to pay benefits earned on free credit balances to the customer.[17]

* * *

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[17] See, e.g., SEC, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., Pt. 1, at 401 (1963).

APPENDIX CC

REPORT OF
SPECIAL STUDY OF SECURITIES MARKETS
OF THE
SECURITIES AND EXCHANGE COMMISSION
PART 1

CONSISTING OF

LETTERS OF TRANSMITTAL OF APRIL 3, 1963, FROM THE CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION AND FROM THE SPECIAL STUDY OF SECURITIES MARKETS, AND THE FOLLOWING CHAPTERS:

CHAPTER I.–INTRODUCTION

CHAPTER II.–QUALIFICATIONS OF PERSONS IN THE SECURITIES INDUSTRY

CHAPTER III.–BROKER-DEALERS, INVESTMENT ADVISERS AND THEIR CUSTOMERS–ACTIVITIES AND RESPONSIBILITIES

CHAPTER IV.–PRIMARY AND SECONDARY DISTRIBUTIONS TO THE PUBLIC

OF THE REPORT OF THE SPECIAL STUDY OF

REPORT OF SPECIAL STUDY OF SECURITIES MARKETS

SECURITIES MARKETS, RELATING TO THE ADEQUACY OF INVESTOR PROTECTION IN THE SECURITIES MARKETS, PURSUANT TO SECTION 19(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (PUBLIC LAW 87-196)

APRIL 3, 1963.–Referred to the Committee on Interstate and Foreign Commerce and ordered to be printed with illustrations

---

U.S. GOVERNMENT PRINTING OFFICE

WASHINGTON : 1963

CHAPTER I

INTRODUCTION

A. THE SPECIAL STUDY OF SECURITIES MARKETS

1. AUTHORITY FOR THE SPECIAL STUDY

On September 5, 1961, section 19(d) of the Securities Exchange Act was enacted, authorizing and directing the Securities and Exchange Commission "to make a study and investigation of the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations, including rules for the expulsion, suspension, or disciplining of a member for conduct

inconsistent with just and equitable principles of trade." The Commission was called upon to report to Congress "the results of its study and investigation, together with its recommendations, including such recommendations for legislation as it deems advisable."[1]

The wording of the law and its legislative history made clear that it contemplated a very broad study of the rules, practices, and problems in the securities business and the securities markets. The existing rules of the exchanges and of the National Association of Securities Dealers, the only existing national securities association, are themselves broad in scope and varied in content. But quite apart from the existing rules, it was made clear that the study was to be concerned with any inadequacy or lack of rules relating to any aspect of the securities business and securities markets, and also with problems that might require legislation or changes in the rules promulgated by the Commission. This was expressed in the report by the House of Representatives

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[1] H.J. Res. 438, 87th Cong., 1st sess. (known as the Mack resolution, after its author, Congressman Peter F. Mack, Jr., then chairman of the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce) became law and Public Law 87-196. The resolution provided for a reporting date of Jan. 3, 1963, and provided $750,000 to carry out the study and investigation. On July 27, 1962, H.R. 11670 became effective as Public Law 87-561, extending the reporting date to Apr. 3, 963, and increasing the authorized appropriation by $200,000.

Committee on Interstate and Foreign Commerce[2] that preceded the enactment of the law:

> During recent months the president of the New York Stock Exchange has issued two very firm warnings against speculation in the stock market. The country's largest brokerage firm has run a dozen newspaper ads urging investor caution , and many other brokerage houses have alerted employees to the danger of uninformed public speculation. The National Association of Securities Dealers has written to all members expressing concern over the very large total of outstanding undelivered transactions. The Chairman of the Securities and exchange Commission has stated that there have been evidences of a substantial amount of manipulation and that they have more manipulation cases in various stages of proceedings than ever before. The Commission has initiated an investigation of the American Stock Exchange to determine whether additional rules or laws are required to insure proper operation of the exchange * * *
>
> Since the market collapse which led to the enactment of the Federal securities laws, there has been a rebuilding of public confidence in the securities markets as a result of both efforts at self-regulation by the industry and the enactment of the statutes and their administration by the Securities and Exchange

---

[2] H. Rept. 882 87th Cong. 1st sess. pp. 2-4 (1961)

> Commission. The maintenance of this confidence is most essential. There has been a great growth and increased activity in the securities markets. It is important to be informed as to whether at this time in the light of changed market conditions the investing public is afforded the protection which was envisaged in the passage of the original legislation. What new statutes or rules are needed? What now unregulated areas of the securities markets need regulations? What rules need change?
>
> * * * * * * * * * *
>
> In view of the comments which recently have been made as to today's market conditions and the testimony before the committee relating to market practices and to violations of statutes and rules, and in view of the nearly 25 years which have elapsed since the last overall study of the operations of securities markets, it seems to this committee that it is now highly appropriate again to review the rules governing the activities of the various securities markets to see whether they are adequate to protect investors, to determine just how they are being administered by the exchanges and the over-the-counter associations, and whether changes, modifications, or expansions of the rules or statutes are desirable now in the public interest.

Awareness of the general nature and scope of these changed conditions coincided with an absence of precise information and data about them. Although the Commission had from time to time conducted specific studies of certain aspects of securities markets, some of the very developments

that had given rise to new questions and problems had so overburdened the Commission and its staff with routine administrative and enforcement work as to preclude adequate study of these changes and of the adequacy of existing regulatory institutions and procedures to deal with them. The creation of what came to be known as the "Special Study of Securities Markets" (Special Study) was thus regarded by the Congress and the Commission itself as a necessary measure to provide comprehensive and current data on both old and new phenomena in the market.

To appreciate the full scope of the new section 19(d) and the significance of its focus on the rules of national securities exchanges and national securities associations, it is necessary to bear in mind the existing pattern of regulatory controls and the expressed purposes of Congress in directing the investigation and report.

CHAPTER II

QUALIFICATIONS OF PERSONS IN THE SECURITIES INDUSTRY

* * *

B. QUALIFICATIONS OF BROKER-DEALERS

* * *

3. PROBLEMS OF FINANCIAL RESPONSIBILITY OF BROKER-DEALERS

Entry qualifications for broker-dealers typically

include requirements aimed at assuring their financial responsibility and stability. The Commission's requirements include Exchange Act rule 15c3-1 which limits the ratio of broker-dealers' "aggregate indebtedness" to "net capital." The laws of many States and the rules of the major exchanges go beyond such net capital ratio rules and impose minimum capital and/or bonding requirements in various amounts and of various types, but these do not cover the majority of broker-dealers.

While net capital ratio rules are desirable and necessary, the stated views of numerous responsible persons in the securities business, the existing minimum capital and bonding requirements imposed by various exchanges and States within their own spheres, and the experience of the Commission all point to the conclusion that these ratio rules alone are not sufficient. A vital element in the generally higher standards of qualification for broker-dealers recommended by the study would be a minimum net capital rule applicable to all registered broker-dealers.

There are numerous reasons. First of all, the securities laws, Federal and State, and the general law of fraud rely heavily on the sanction of civil liability in favor of those who may be injured by violations of broker-dealers.

CHAPTER III

BROKER-DEALERS, INVESTMENT ADVISERS AND THEIR CUSTOMERS–ACTIVITIES AND RESPONSIBILITIES

REPORT OF SPECIAL STUDY OF SECURITIES MARKETS

SUMMARY TABLE OF CONTENTS

A. Introduction.
B. Selling Practices.
C. Research and Investment Advice.
D. Protection of Customers' Funds and Securities.
E. Delivery of Securities.
F. The Broker-Dealer as Corporate Director.

DETAILED TABLE OF CONTENTS

* * *

D. PROTECTION OF CUSTOMERS' FUNDS AND SECURITIES

1. Conduct of customers' accounts 387
   a. Purpose study 387
   b. Method of study 388
   c. Types of accounts 388
   d. The nature of agreements between broker-dealers and their customers . . . 390
   e. Notice to customers as to status of accounts 391
2. Customers' assets in possession of broker-dealers 393
   a. Free credit balances 393
   b. Other cash equities of customers 397
   c. Customers' fully paid securities 397
   d. Customers' securities in margin accounts 398
3. Existing rules, regulations and practices 399

a. Rules relating to free credit balances . . 399
b. Rules relating to segregation of securities 402
c. Rules relating to hypothecation and lending of securities 404
d. Net capital ratio rule 407
4. Provisions of bankruptcy law 410
a. Section 60(e) and related doctrines . . . 410
b. Problems arising from broker-dealer insolvency 412
5. Summary, conclusions and recommendations . 414

CHAPTER III

BROKER-DEALERS, INVESTMENT ADVISERS AND THEIR CUSTOMERS–ACTIVITIES AND RESPONSIBILITIES

A. INTRODUCTION

1. LEGAL AND ETHICAL OBLIGATIONS OF THE INDUSTRY TO THE PUBLIC

The legal restraints and ethical standards surrounding the securities industry are frequently and rather loosely covered by the umbrella phrase of "fiduciary and quasi-fiduciary obligations." The phrase is perhaps overused, and may obscure significant distinctions between actual legal obligations and ethical ideals. Nevertheless, its use does correctly indicate that brokers, dealers, investment advisers, and their employees have special obligations to deal fiarly with the members of the public, whether they be called

customers or clients, and that these obligations are above and beyond the ordinary obligations imposed on sellers of other types of merchandise. These obligations are imposed both by Federal and State laws relating to the sale of securities, and by the rules, regulations, and practices of the national securities exchanges and the National Assocition of Securities Dealers, Inc. A brief review of the most significant legal and ethical obligations affecting the industry is necessary to an understanding of the material which follows.

The obligations of broker-dealers and their salesmen to the purchasers of securities recommended by them may well be the area in which the legal and ethical obligations have been most frequently defined and least effectively achieved. In the often reiterated words of the Commission, the represenation that the purchaser "will be dealt with fairly in accordance with the standards of the profession" is basic to the relationship between a broker-dealer and his customer.[1] An obligation of fair dealing, based upon the general antifraud provisions of the Federal securities laws,[2] rests upon the theory that even a dealer at arm's length impliedly represents when he hangs out his shingle that he will deal fairly with the public. . . . In another line of cases, the Commission has held that where a relationship of trust and confidence has been developed between a broker-dealer and his customer so that the customer relies on his advice, a fiduciary relationship

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[1] *Duker & Duker*, 6 S.E.C. 386 (1939).

[2] Sec. 17(a) of the Securities Act and secs. 10(b) and 15(c)(1) of the Exchange Act. See also rule 10b-5 promulgated under sec. 10(b) of the Exchange Act.

exists, imposing a particular duty to act in the customer's best interests and to disclose any itnerest the broker-dealer may have in transactions he effects for his customer.[9]

* * *

D. PROTECTION OF CUSTOMERS' FUNDS AND SECURITIES

1. CONDUCT OF CUSTOMERS' ACCOUNTS

a. Purpose of study

The purpose of this part is to continue the study of the broker-dealer financial responsibility rules begun in chapter II.B. There, bonding and minimum capital rules that have an impact at the point of entry into the business were examined; here certain rules governing the conduct of broker-dealer business operations are reviewed. The rules discussed relate to custody and use of customers' assets, and to net capital ratios. It is appropriate to consider whether they provide adequate protection to investors by reducing the probability of broker-dealer insolvency and by correlating adequately with the provisions of Federal bankruptcy law in the event that such an insolvency occurs.

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[9] *J. Logan & Co.*, Securities Exchange Act release No. 6848 (July 7, 1962); *May & Phinney*, 27 S.E.C. 814 (1948); *Arleen W. Duches*, 27 S.E.C. 629 (1948), aff'd sub. nom.; *Hughes v. S.E.C.* 174 F.2d 969 (D.C. Cir. 1949); *Allender & Co.*, 9 S.E.C. 1043 (1949).

The rules treated include those embodied in certain State and Federal statutes and those of the Commission, national securities exchanges, and the NASD. Their adequacy, in substance and enforcement, is fundamental to the health of the securities business because the broker-dealer community regularly has custody of and uses customers' funds and securities of enormous value. Substantial unprotected losses to the public resulting from misuse of customers' assets or other practices which the rules are intended to protect against, would cause, in addition to injury to the public, serious harm to the industry's reputation.

* * *

4. The broker-dealer is authorized to borrow for a customer any securities which may be necessary in order to effect sales ordered by that customer if he is unable to make delivery.

Additionally, the customer is required to sign a separate loan consent that typically reads as follows:

> Until you receive written notice of revocation signed by the undersigned, you are hereby authorized to lend, to yourselves as brokers or to others, any securities sold by you on margin for the account of, or under the control of the undersigned.

The terms of the usual margin agreement are entirely for the benefit of the broker-dealer, except that the agreement typically states that all transactions thereunder are subject to the constitution, rules, regulations, customs and usages of the

exchange or market where the transaction is executed and also subject to the provisions of various State and Federal regulatory laws, rules, and regulations. This one sidedness is not necessarily improper. It is obviously vital that the broker-dealer who lends money to his customers have a wide measure of freedom of action in order to protect himself in the event of a break in the market, or in the value of securities in a particular account. Inflexibility, indeed, might lead to impairing the broker-dealer's solvency and jeopardizing his other customers' funds. The one-sided nature of these agreements indicates, however, the importance of the rules and regulations of various State and Federal regulatory agencies as well as those of the exchanges and the NASD in providing rights and protection for customers.

* * *

2. CUSTOMERS' ASSETS IN POSSESSION OF BROKER-DEALERS

Generally speaking, the customers' assets of which broker-dealers have custody fall into four categories: customers' "fre credit" balances; customers' cash balances other than free credit balances; customers' "fully paid" securities; and customers' securities in margin accounts.[323] The financial responsibility rules should be considered in light of the means by which broker-dealers acquire and hold these

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[323] No attempt is made in this report to discuss problems arising in connection with commodities accounts or nonpurpose loan accounts. With respect to the latter, see ch. X.

assets and the purposes for which they are used.

a. Free credit balances

Free credit balances are those amounts of cash owed by broker-dealers to customers which the customers have an immediate, unrestricted right to withdraw. The NYSE explains the term as follows: "The cash credit balance available in customers' accounts for use by the customers. A credit balance caused by a short sale is not a free credit balance."[324]

Free credit balances come into being in the normal course of the broker-dealers' business. The balances are created, typically, when a customer gives cash to a broker-dealer with the advice that instructions for the purchase of securities will follow; or a customer instructs a broker-dealer to sell securities and the broker-dealer, either on its own intiiative or upon the direction of the customer, holds the proceeds pending reinvestment or other instructions; or, a broker-dealer receives and does not immediately transmit interest and dividends on customers' securities he holds in "street" name.[325]

Although precise figures as to the balances held by all broker-dealers in the country are unavailable, some idea of their magnitude may be gained from the available figures with respect to NYSE member firms which numbered 681 on January 1, 1962. Month-end free credit balances reported by

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[324] New York Stock Exchange Fact Book (1962), p. 26.

[325] See app. III-D.

these firms varied between totals of $1,207 million and $1,508 million during 1961.[326] It is possible that the member firms of the NYSE account for a large portion of free credit balances held by all registered broker-dealers in the country, but holding of free credit balances is by no means restricted to such firms. The Washington regional office of the Commission conducted a study of 66 of the 141 registered broker-dealers in Washington, D.C., as of March 31, 1962. Eleven were member firms of one or more registered national securities exchanges and 55 were not. The 11 exchange member houses held free credit balances of $6,619,000, while the 55 non-member houses held free credit balances of $281,000.

The likelihood that a firm will come into possession of and hold free credit balances of its customers depends on its type of business. A retailer of mutual funds, for example, will be most unlikely to come into possession of substantial customers' funds. The difference between such a firm and the large wire house is dramatically illustrated by comparing the annual financial reports to the Commission of the 10 largest wire houses in the country with 10 largest mutual-fund retailers.[327] The former reported aggregate free credit balances of $428,496,529, while the latter held only $175,581.[328]

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[326] See NYSE Fact Book, p. 27.

[327] Both categories are measured by number of salesmen.

[328] The figures are aggregated here although the financial reports to the Commission, from which they were compiled, were

Similarly, a small broker-dealer who buys and sells securities for customers in limited amounts and in conjunction with another business he is conducting is less likely to hold extensive free credit balances. Naturally this is not invariably true and instances can be found in which small broker-dealers hold amounts of free credit balances that are large in relation to their net capital. It is among the large broker-dealers, however, such as the wire houses, that free credit balances are held in enormous volumes. Merrill Lynch, Pierce, Fenner & Smith, Inc., for example, in its annual report to the Commission for 1961 stated that on May 26, 1961, it held approximately $233 million in free credit balances. This is by far the largest firm in the country, but other firms hold free credit balances in amounts running into millions of dollars.

From the point of view of the broker-dealer, free credit balances repreent a desirable source of funds since generally they can be used interest free.[329]

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not all filed at the same time. The figures used were the latest available as of Dec. 31, 1961.

[329] Customers' securities can be lent to other broker-dealers with much the same advantage for the lending broker-dealer as that derived from using free credit balances. Normally, the borrowing broker-dealer deposits cash in the amount of the full market value of the borrowed securities, and nowadays the loan usually is "flat," i.e., the borrowing broker-dealer pays no premium and the lending broker-dealer pays no interest on the deposit. The disadvantages in lending customers' securities are that certain written consents must be obtained and there may be some effort in finding another broker-dealer interested in borrowing the securities.

* * *

Whatever the real or imagined restrictions on paying interest on free credit balances, there appear to be no restrictions, except in a few jurisdictions[334] on the use of free credit balances for the purposes of the firm. All firms may use these balances to maintain positions in securities or otherwise in their general operations. Firms carrying margin accounts may use the balances to finance loans to margin customers; normally money is lent to margin customers at the going call-money rate plus one or one-half point. Although the firms' overhead cost of landing money cannot be readily determined, it is apparent that those using customers' funds have a considerable profit margin in such transactions.[335]

The importance of broker-dealers' loans to customers for purchasing or carrying securities is indicated by the fact

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While free credit balances are, by definition, subject to instantaneous withdrawal by customers, a broker-dealer can count on a certain amount of stability and regularity of both the inflow and outflow of such balances. Merrill Lynch, for example, has estimated that the inflow and outflow of its large free credit balances represents "float," i.e., items which it will retain only for a brief period before transmittal to customers. The remainder represents amounts which it may hold for an extended period of time.

[334] See sec 3 a.

[335] For a discussion of the effect on broker-dealer income of the use of customers' free credit balances for lending, see ch. VI.

that, at the end of December 1961, the net debit balances of customers of NYSE firms, secured by U.S. Government and all other obligations, were $4,298 million.[336] At the same date, the total of bank loans to persons other than broker-dealers for purchasing or carrying securities was $2,134 million.[337]

* * *

3. EXISTING RULES, REGULATIONS, AND PRACTICES

There is a considerable body of financial responsibility rules governing segregation and use by broker-dealers of customers' funds and securities and requiring capital to be maintained proportionately to aggregate indebtedness.

a. Rules relating to free credit balances

Of the varieties of customers' assets which are retained in the hands of broker-dealers, free credit balances would surely seem to need the most protection. In the absence of any rules requiring segregation they may be, and often are, used for the general operating needs of the broker-dealer's business, for financing its trading and investment accounts or for loans to other customers to finance margin transactions. In he event of insolvency, the protection accorded customers' free credit balances even under the Bankruptcy Act is limited.

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[336] Federal Reserve Bulletin, January 1962, p. 62.

[337] Federal Reserve Bulletin, November 1962, p. 1468.

Yet it is these balances that are accorded the least direct protection under other Federal or State law, or the rules of the self-regulatory organizations.

The Commission, in 1941, proposed that it be given power to require segregation of free credit balances by rule. The proposal, which was vigorously opposed by the securities industry, has never been adopted.[348]

Neither the exchanges nor the NASD require segregation. The NASD does "recommend" that its members either segregate deposits against "when, as, and if issued" and "when, as, and if distributed" transactions[349] or that they maintain aggregate bank balances equal to such deposits, but the recommendation is not a requirement. Indeed, implicit in the recommendation is the assumption that drawing down bank balances below the aggregate amount of customers' free credit balances is a normal procedure. It is a practice, however, that apparently is considered undesirable by a

---

[348] Report of SEC on proposals for amendments to the Securities Act of 1933, and the Securities Exchange Act of 1934, printed for House of Repreentatives Committee on Interstate and Foreign Commerce, 77th Cong., 1st sess., 29-32 (1941). The Commission has adopted rule 206(4)-2 under the Investment Advisers Act of 1940 requiring investment advisers to maintain separate bank accounts for customers' balances.

[349] NASD Manual, p. F-27. These transactions are purchases of securities which are not available for delivery. They comprise a minute percentage of all securities transactions.

segment of the NASD's own membership[350] since 90 of the 228 respondents to FR-1 reported that they voluntarily maintain bank balances equal to or greater than customers' free credit balances; further, an additional 16 respondents to FR-1 reported that they voluntarily segregated free credit balances.

Under the laws of some of the States, specific restrictions do exist upon the manner in which customers' free credit balances may be held. For example, Iowa requires that customers' free credit balances be segregated from firm accounts. Ohio requires that customers' free credit balances be segregated if the net capital of a broker-dealer falls below $10,000 or his "total indebtedness" exceeds 15 times his "net worth." Apart from State law, however, there are no direct restrictions on the manner in which customers' free credit balances are held and used by broker-dealers.

* * *

Segregating or otherwise safeguarding customers' free credit balances has been a subject of discussion for many years. At least two reasons may be advanced for requiring the segregation of free credit balances. First, it is argued that there are questions as to the propriety of broker-dealers' being able freely to use customers' funds. Second, it is argued that customers are not protected from exposure to loss in the event of broker-dealers' insolvency; and that segregation together

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[350] All broker-dealers in the FR-1 sample are members of the NASD.

with appropriate changes in the Bankruptcy Act would afford such protection.

. . . Use of free credit balances accounts for important additions to the income of many firms in the securities industry. Withdrawal of that source of income would have to be considered in the light of its effect upon the services now provided by the industry.

Certain protections for free credit balances, not now generally provided, are both desirable and feasible. Free credit balances are subject to demands for immediate withdrawals and broker-dealers have an obligation to maintain themselves in a position such that these demands can be met without resort to forced sales of securities or other undesirable means. . . .

It would seem desirable that broker-dealers likewise be required to maintain reserves of cash or Government obligations equal to a percentage of free credit balances. . .

Reserves and liquidity apart, customers are often unaware of the status of their free credit balances–that their free credit balances are in fact being used by the firm holding them and that they are vulnerable in the event of insolvency. The question may appropriately be raised whether broker-dealers should be entitled to use their customers' assets without notifying the customers or obtaining their specific consent. . . .

* * *

A few States have adopted rules requiring segregation of customers' securities from firm securities. Among these are Iowa,[361] Michigan,[362] and Ohio.[363]

* * *

The Special Study concludes and recommends:

1. The net capital rules of the Commission and the self-regulatory agencies should be amended to require broker-dealers to maintain a reserve of, say, 15 percent of the aggregate amount of free credit balances in the form or cash or short-term U.S. Government securities; or in the alternative, if a lesser reserve is maintained, toc harge the difference to net capital. In addition, broker-dealers holding free credit balances should be required to give customers at least quarterly notice of the amounts of such balances. Such notice should include information to the effect that their free credit balances may be withdrawn at any time; that while held by the firm they are not segregated and may be lent to other customers or otherwise used in the business of the firm; that interest is not paid on such balances (or the circumstances in which

---

[361] Iowa Securities Division Order No. 3 (May 20, 1949).

[362] Regulations, sec. 115, adopted pursuant to act 220, P.A. 1923.

[363] The duty is limited to broker-dealers not meeting certain capital requirements. Other exceptions are also provided; see note 352.

interest is paid); and that financial statements of the broker-dealer firm are available for inspection.

* * *

APPENDIX DD

RESTATEMENT (SECOND) OF TRUSTS s 203 (1957 MAIN VOL.)

Restatement of the Law Second Trusts 2d
Chapter 7. The Administration of the Trust
Topic 4. Remedies of the Beneficiary and Liabilities

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s 203. ACCOUNTABILITY FOR PROFITS IN THE ABSENCE OF A BREACH OF TRUST

The trustee is accountable for any profit made by him through or arising out of the administration of the trust, although the profit does not result from a breach of trust.

Comment:

a. Scope of the rule. If the trustee enters into a transaction in connection with the administration of the trust for the purpose of acquiring a profit for himself in violation of his duty of loyalty to the beneficiary, he commits a breach of trust under the rule stated in s 170, and is liable under the rule stated in s 206. Even if he enters into the transaction without intending to make a profit for himself and commits no breach of trust in so doing, nevertheless he is not permitted to retain the profit. Thus, if the trustee receives a commission or bonus for acts done in connection with the administration of the trust, he is accountable therefor, even if he does not commit a breach of trust in receiving the commission or

bonus.

b. Profit made through the use of trust property. If the trustee makes a profit out of the trust property, he is accountable for the profit although he commits no breach of trust in making the profit. Thus, if the trustee receives payment for the use of the trust property, he is accountable for the money received, as for example where the trustee of a farm receives payment from a third person for the privilege of hunting on the farm. If the trustee makes an authorized investment in securities which he sells at a profit, he is of course accountable for the profit.

* * *

d. Profit made through use of trustee's individual property. Even if the profit is made by the use of the trustee's individual property and he does not commit a breach of trust in making the profit, he may be accountable for the profit. Thus, if the trustee with his own funds purchases an encumbrance upon the trust property for the purpose of protecting the trust property, he is accountable for any profit he makes thereby.

* * *

APPENDIX EE

RESTATEMENT (THIRD) OF TRUSTS, P.I.R., s 213 (1990 MAIN VOL.)

Restatement of the Law Third
Trusts 3d
Prudent Investor Rule
Other Sections Affecting or Affected by the Prudent Investor Rule, with Comment and Reporter's Notes to Those Sections
Chapter 7. the Administration of the Trust
Topic 4. Remedies of the Beneficiary and Liabilities of the Trustee

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s 213. BALANCING LOSSES AGAINST PROFITS

* * *

a. Scope of Section.

* * *

It is fundamental that the trustee is accountable for all profits arising out of the administration of the trust, whether or not they result from breach of trust. See s 203. The beneficiaries are entitled to the benefit of those profits reduced by losses that result from proper administration of the trust. See s 204.

* * *

b. Meaning of "loss" and "profit." The loss from a breach of trust is the amount necessary to restore the value of the beneficiaries' interests to what their value would have been if the trust had been properly administered.

* * *

APPENDIX FF

APPEALS TO COURT OF APPEALS

§5602. Appeals to the court of appeals by permission.

(a) Permission of appellate division or court of appeals. An appeal may be taken to the court of appeals by permission of the appellate division granted before application to the court of appeals, or by permission of the court of appeals upon refusal by the appellate division or upon direct application. Permission by an appellate division for leave to appeal shall be pursuant to rules authorized by that appellate division. Permission by the court of appeals for leave to appeal shall be pursuant to rules authorized by the court which shall provide that leave to appeal be granted upon the approval of two judges of the court of appeals. Such appeal may be taken:

1. in an action originating in the supreme court, a county court, a surrogate's court, the family court, the court of claims, an administrative agency or an arbitration,

(i) from an order of the appellate division which finally determines the action and which is not appealable as of right, or

* * *

APPENDIX GG

15,242 EXCHANGE ACT–LAW TEXT

[¶20,561] EFFECT ON EXISTING LAW

Sec. 28. (a) The rights and remedies provided by this title shall be in addition to any and all other rights and remedies tht may exist at law or in equity; but no persom permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. Nothing in this title shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this title or the rules and rgulations thereunder. No State law which prohibits or regulates the making or promoting of wagering or gaming contracts, or the operation of "bucket shops" or other similar or related activities, shall invalidate any put, call, straddle, option, privilege, or other security, or apply to any activity which is incidental or related to the offer, purchase, sale, exercise, settlement, or closeout of any such instrument, if such instrument is traded pursuant to rules and regulations of a self-regulatory organization that are filed with the Commission pursuant to section 19(b) of this Act.

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No. 97-1491

In The

Supreme Court of the United States

October Term, 1997

THE ESTATE OF DAVID J. BRAUNSTEIN and ROSEMARIE BRAUNSTEIN, *et al.*,

Petitioners,

vs.

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, *et al.*,

Respondents.

On Petition for Writ of Certiorari to the Court of Appeals of the State of New York

RESPONDENTS' BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether the federal regulatory scheme permitting securities broker-dealers to use customer free credit balances in their business for specified purposes would be compromised by state common law requirements that broker-dealers pay any economic benefits from such use directly to their customers, where Congress and the SEC have recognized the existence and utility of retention by broker-dealers of benefits from such use.

RULE 29.6 STATEMENT

The following are the parent companies or nonwholly owned subsidiaries of respondents:

The parent of respondent Merrill Lynch, Pierce, Fenner & Smith, Inc. is Merrill Lynch & Co., Inc. The only non-wholly owned subsidiary of Merrill Lynch, Pierce, Fenner & Smith, Inc. is Merrill Lynch Professional Clearing Corp.

Neither respondent Prudential Securities, Inc. nor its ultimate parent, The Prudential Insurance Company of America, a mutual insurance company, nor any subsidiary or affiliate has issued shares to the public.

Respondent Smith Barney Shearson, Inc. is now Smith Barney, Inc. The direct parent of Smith Barney, Inc. is Salomon Smith Barney Holdings Inc., and the ultimate parent of Smith Barney Inc. is Travelers Group Inc. Smith Barney, Inc. does not have any non-wholly-owned subsidiaries.

Respondents Kemper Securities Group, Inc. and Kemper Securities, Inc. are now EVEREN Securities, Inc. The parent of EVEREN Securities, Inc. is EVEREN Capital Corporation. EVEREN Securities, Inc. does not have any non-wholly-owned subsidiaries.

The ultimate parent of respondent Dean Witter Reynolds, Inc. is Morgan Stanley Dean Witter & Co. The only non-wholly owned subsidiary of Dean Witter Reynolds, Inc. is SPS Transaction Services, Inc.

Respondent Alex, Brown & Sons, Inc. is now BT Alex. Brown Incorporated. The parents of BT Alex. Brown Incorporated are Bankers Trust New York Corporation and BT

Alex. Brown Holdings Incorporated. The only non-wholly owned subsidiary of BT Alex. Brown Incorporated is Alex. Brown Investment Management Incorporated.

The ultimate parent of respondent Bear, Stearns Securities Corp. is The Bear Stearns Companies. Bear, Stearns Securities Corp. does not have any non-wholly-owned subsidiaries.

The ultimate parent of respondent Charles Schwab & Co., Inc. is The Charles Schwab Corporation. Charles Schwab & Co., Inc. does not have any non-wholly-owned subsidiaries.

Respondent Kidder Peabody & Co., Incorporated is now a wholly-owned subsidiary of Paine Webber Group, Inc.

The only parent, subsidiary, or affiliate of respondent PaineWebber, Inc. that is publicly held is Paine Webber Group, Inc.

Respondent Lehman Brothers, Inc. ("Lehman") has the following parent: Lehman Brothers Holdings, Inc. ("Holdings"). Holdings is a public company. No other Lehman affiliates have offered shares or other obligations to the public.

TABLE OF CONTENTS

	Page
Question Presented	i
Rule 29.6 Statement	ii
Table of Contents	iv
Table of Citations	vi
Opinions Below	1
Statement of the Case	1
A. The Proceedings In The New York Courts	3
Reasons for Denying the Writ	5
I. The New York Courts Properly Applied This Court's Preemption Decisions To The Interaction Between The Federal Regulatory Scheme Governing Free Credit Balances And Petitioners' State Common Law Claims.	6
A. Federal Regulation of Free Credit Balances	6
1. "Free Credit Balances"	6
2. Broker-Dealers' Treatment of Free Credit Balances Is Pervasively Regulated	6

Contents

	Page
a. Congress	7
b. SEC	7
B. The New York Courts Properly Applied This Court's Preemption Standards	11
1. This Court Has Consistently Held That State Laws That Conflict With The Purposes and Objectives of Federal Regulation Are Preempted	11
2. Petitioners' State Common Law Claims Conflict With The Purposes and Objectives of The Federal Regulatory Scheme	13
II. There Is No Conflict Between The Legislative Purpose Of Section 28(a) Of The Exchange Act And The Lower Courts' Finding That Petitioners' Claims Are Preempted.	17
III. The Facts Of This Litigation Are Unique And Unlikely To Recur.	22
Conclusion	25

Contents

Page

TABLE OF CITATIONS

Cases Cited:

Barnett Bank v. Nelson, 517 U.S. 25 1996) 12, 14

Capital Cities Cable Inc. v. Crisp, 467 U.S. 691 (1984) 11, 12, 14

Carr v. CIGNA Secs., 95 F.3d 544 (7th Cir. 1996) ... 24

Carstensen v. Brunswick Corp., 49 F.3d 430 (8th Cir.), *cert. denied*, 516 U.S. 866 (1995) 16

CSX Transportation, Inc. v. Easterwood, 507 U.S. 658 (1993) 12

Dahl v. Charles Schwab & Co., 545 N.W. 2d 918 (Minn.), *cert. denied*, 117 S. Ct. 176 (1996) 22

Dumont v. Charles Schwab & Co., Nos. 96-C-2685 & 97-CA-1225 (La. Ct. App. 4th Cir. Apr. 8, 1998) .. 22

Edgar v. MITE Corp., 457 U.S. 624 (1982) 15, 18

Eirman v. Olde Discount Corp., 697 So. 2d 865 (Fla. Dist. Ct. App.), *certification denied*, (Fla. Aug. 28, 1997) 22

Fekety v. Gruntal & Co., 191 A.D. 2d 370, 595 N.Y.S. 2d 190 (N.Y.A.D. 1st Dep't 1993) 23-24

Contents

	Page
Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141 (1982)	12
Freightliner Corp. v. Myrick, 514 U.S. 280 (1995)	15, 16
Guice v. Charles Schwab & Co., 89 N.Y. 2d 31, 674 N.E. 2d 282, 651 N.Y.S. 2d 352 (1996), *cert. denied*, 117 S. Ct. 1250 (1997)	4, 5, 18, 19, 20, 21, 22
Hillsborough Co., Florida v. Automated Med. Labs, Inc., 471 U.S. 707 (1985)	12
In Re Prudential Secs., Inc. Sweep Litigation, No. 122747/95 (N.Y. Sup. Ct. N.Y. Cty. Jun. 24, 1997)	22, 23
International Paper Co. v. Ouellete, 479 U.S. 481 (1987)	12, 18
Matter of Atkeison, 446 F. Supp. 844 (M.D. Tenn. 1977)	7
Medtronic v. Lohr, 518 U.S. 470, 116 S. Ct. 2240 (1996)	16
Michigan Canners & Freezers Ass'n v. Agricultural Marketing and Bargaining Bd., 467 U.S. 461 (1984)	18
Orman v. Charles Schwab & Co., 688 N.E. 2d 620 (Ill. 1997), *petition for cert. filed* (Feb. 18, 1998) (No. 97-1367)	22

Contents

Page

Paccar, Inc. v. NHTSA, 573 F.2d 632 (9th Cir.), *cert. denied*, 439 U.S. 862 (1978) 15

Perl v. Smith Barney Inc., 230 A.D.2d 664, 646 N.Y.S.2d 678 (N.Y.A.D. 1st Dep't), *appeal denied*, 89 N.Y.2d 803, 675 N.E.2d 1234, 653 N.Y.S.2d 281 (N.Y. 1996) 23

Pokorny v. Ford Motor Co., 902 F.2d 1116 (3d Cir.), *cert. denied*, 498 U.S. 853 (1990) 16

Press v. Chemical Inv. Servs., No. 96 Civ. 8331, 1997 WL 795100 (S.D.N.Y. Dec. 22, 1997) 24

Ray v. Atlantic Richfield Co., 435 U.S. 151 (1987) ... 16

Schneidewind v. ANR Pipeline Co., 485 U.S. 293 (1988) 11

Securities Indus. Ass'n v. Connolly, 883 F.2d 1114 (1st Cir. 1989), *cert. denied*, 495 U.S. 956 (1990) 12

Shulick v. Paine Webber, Inc., 700 A.2d 534 (Pa. Super. Ct. 1997) 22

Surrey Strathmore Corp. v. Dollar Sav. Bank, 36 N.Y. 2d 173, 325 N.E. 2d 527, 366 N.Y.S. 2d 107 (1975) 24

Contents

Page

Statutes Cited:

15 U.S.C.A § 78(b) (West 1981) 7

15 U.S.C.A. § 78o(c)(3) (West Supp. 1996) 7, 21

15 U.S.C.A. § 78bb(a) (West 1981) 5, 17, 18, 19, 24

United States Constitution Cited:

U.S. Const., art. VI, cl. 2. 11

Other Authorities Cited:

17 C.F.R. § 240.15c3-2 .....7, 8, 13, 14

17 C.F.R. § 240.15c3-3 ..... 1, 7, 9, 10, 13, 21

17 C.F.R. § 240.15c3-3(a)(8) 2, 6

17 C.F.R. § 240.15c3-3(e) 7, 8

CPLR Rule 3013 4

CPLR Rule 3016(b) 4

Adoption of Rule 15c3-2, Exchange Act Release No. 34-7325, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,000 at 81,668 (May 27, 1964) 8, 9, 15

Contents

Page

Proposed Rule 15c3-2, Exchange Act Release No. 34-7266, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,978 at 81,622 (Mar. 12, 1964) 9, 15

H. Rep. No. 91-1613, 91st Cong., 2d Sess. (1970), *reprinted in* 1970 U.S.C.C.A.N. 5254, 5255-56 ... 7

In re Newman (Ann), SEC No-Action Letter, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,177 at 80,545 (May 6, 1971) 10, 13, 24

Notice to Broker-Dealers Concerning Interest-Bearing Free Credit Balances, Exchange Act Release No. 34-18262, 4 Fed. Sec. L. Rep. (CCH) ¶ 25,134B at 18,327-3 (Nov. 17, 1981) 9-10, 13

Proposal to Adopt Rules 15c3-3 and 15c3-4 and to Amend Rules 8c-1 and 15c2-1, Exchange Act Release No. 34-9388, 1971 WL 16389, at *6 (Nov. 8, 1971) 8, 9, 13, 15, 21

Adoption of Rule 15c3-3, Exchange Act Release No. 34-9856, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,083 at 82,346 (Nov. 13, 1972) 8

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SEC, Report of Special Study of Securities Markets, H. Doc. No. 95, 88th Cong., 1st Sess., Pt. 1, at 391-401, 415 (1963) 10, 11, 13, 21

Contents

	Page
New York Stock Exchange, Inc. Rule 436, NYSE Guide (CCH) ¶ 2436 (1990)	10
Weinstein-Korn-Miller, *New York Civil Practice: CPLR*, ¶ 5601.09, at 56-46 (Matthew Bender 1996)	5
Hon. Frank Horton, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2027 (Mar. 12, 1983)	10
APPENDIX	
Appendix A — Motion And Memorandum Opinion Of The Supreme Court Of The State Of New York, New York County Filed October 2, 1996	1a
Appendix B — Motion And Memorandum Decision Of The Supreme Court Of The State Of New York, New York County In *Sandra Ballan v. Prudential Securities, Inc.* Filed June 24, 1997	20a

Respondents, eleven leading securities broker-dealers, respectfully request that this Court deny the petition for a writ of certiorari.

OPINIONS BELOW

The opinions of the Supreme Court of the State of New York, County of New York (the "trial court") dismissing petitioners' initial complaint for lack of particularity and denying respondents' motion to dismiss the amended complaint are published, respectively, at N.Y.L.J., Jun. 22, 1995, at 29, col. 4, and N.Y.L.J., May 16, 1996, at 27, col. 4. (Petitioners' Appendix ("Pet. App.") A38, A154). The opinion of the trial court denying class certification is published at N.Y.L.J., Oct. 2, 1996, at 22, col. 5. (Respondent's Appendix ("Resp. App.") 1a). The opinion of the Supreme Court of the State of New York, Appellate Division, First Department ("Appellate Division") is reported at 238 A.D. 2d 242, 657 N.Y.S. 2d 12. (Pet. App. A34). The Decision and Order of the New York Court of Appeals ("New York Court of Appeals") dismissing the appeal as of right is reported at 90 N.Y. 2d 934, 686 N.E. 2d 1366, 664 N.Y.S. 2d 271. (Pet. App. A26). The Decision and Order of the New York Court of Appeals denying the motion for leave to appeal is reported at 91 N.Y. 2d 803. (Pet. App. A31).

STATEMENT OF THE CASE

At issue in this action is which law, federal or state, regulates the obligations of securities broker-dealers to their customers in handling cash — referred to as "free credit balances" — arising in customers' brokerage accounts.[1] The federal regulatory

1. Free credit balances are defined in Rule 15c3-3 of the Securities Exchange Act of 1934 ("Exchange Act") as "liabilities of a broker or dealer to customers which are subject to immediate cash (Cont'd)

scheme expressly permits broker-dealers to use customers' free credit balances in the operation of specific areas of their businesses, subject to certain disclosure requirements. Both the Securities and Exchange Commission ("SEC") and Congress have recognized that securities industry practice generally is not to make payments to customers for the use of such balances, and that customers benefit from such use. The SEC also has rejected specific proposals that free credit balances be treated as trust funds, and has instead declared that the payment of interest to customers on free credit balances is a matter of contract, not a matter of right, between the individual customer and the broker-dealer as creditor and debtor. Petitioners challenge the conclusion of the Appellate Division that this carefully designed federal scheme would be "severely compromised" by, and therefore preempts, application of state law to require payments to customers for the use of free credit balances. (Pet. App. A37).

Petitioners are or were brokerage customers of respondents, eleven leading registered securities broker-dealers.[2] Petitioners purport to bring this action on behalf of a massive, unmanageable class.[3] Petitioners claim, without setting forth

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(Cont'd)
payment to customers on demand, whether resulting from sales of securities, dividends, interest, deposits or otherwise . . . ." Exchange Act Rule 15c3-3(a)(8), 17 C.F.R. § 240.15c3-3(a)(8) (1996).

2. Not all petitioners are customers of all respondents.

3. The class was defined as:

> All persons or entities in the United States who have, or have had accounts with one or more of the respondents in which they have had free credit balances which existed overnight or longer from which the respondents

(Cont'd)

any particulars, that respondents "create" and then "use their customers' free credit balances, generate an economic benefit from this use and retain such economic benefit as their own." (Pet. App. A52 at ¶ 3). Petitioners also allege that respondents have "delayed the transfer of the Plaintiffs' and Class members' free credit balances, enabling them to further retain and use these free credit balances for their own profit." (*Id.*). Based on these generalized allegations, the amended complaint asserts state common law claims for breach of fiduciary duty and unjust enrichment. (Pet. App. A78-81 at ¶¶ 29-41). Petitioners seek an accounting and restitution for any gain or economic benefit derived from respondents' use of the free credit balances existing overnight or longer in petitioners' accounts and allegedly retained by respondents. (Pet. App. A51 at ¶ 1). In addition, petitioners seek a temporary and permanent injunction enjoining respondents from continuing the practices complained of, as well as a declaratory judgment that respondents' acts are illegal. (Pet. App. A81-82).

A. The Proceedings in the New York Courts

Respondents moved to dismiss the initial complaint in this action on the grounds that, *inter alia*, petitioners' claims were

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(Cont'd)

> have received economic benefit for which the respondents have not properly accounted to the petitioners.

(Pet. App. A60 at ¶ 11.). The trial court refused to certify the class because, *inter alia*, it found that petitioners "have failed to show that a *common* 'method and procedure' was adopted by defendants whereby free credit balances were unnecessarily created, delayed, or retained" and "have not made it at all clear who they seek to represent." Resp. App. 13a, 18a (emphasis in original).

preempted by federal law.[4] The trial court denied respondents' federal law grounds for dismissal but dismissed the complaint with leave to replead on the grounds that petitioners failed adequately to plead causes of action for breach of fiduciary duty and unjust enrichment, pursuant to Section 3013 and Rule 3016(b)[5] of the New York Civil Practice Law and Rules ("CPLR"). (Pet. App. A154). Petitioners then filed an amended complaint. (Pet. App. A150). Respondents again moved to dismiss; the trial court denied the motion. (Pet. App. A38). Defendants appealed both orders. While the appeal was pending, the trial court denied class certification. (Resp. App. 1a).

The Appellate Division reversed the trial court and dismissed the action as preempted by federal law.[6] The court relied primarily on a recent decision of the New York Court of Appeals, a decision with respect to which this Court denied certiorari. *Guice v. Charles Schwab & Co.*, 89 N.Y. 2d 31, 674 N.E. 2d 282, 651 N.Y.S. 2d 352 (1996), *cert. denied*, 117 S. Ct. 1250 (1997). Following the Appellate Division's dismissal,

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4. Prior to the filing of this action, petitioners filed a predecessor action in Arizona Superior Court. The case was stayed on forum non conveniens grounds; that stay is still in effect.

5. CPLR Rule 3016(b) requires that breaches of trust be pleaded with particularity.

6. The petition characterizes the Appellate Division's opinion as "incorrectly focusing on the permissive use of free credit balances (an issue that was never contested by petitioners) rather than the fruits of such usage." Pet. 2-3. In fact, that court described petitioners' claims as "seek[ing] an accounting and restitution of *any benefit received* by defendants *from use* of free credit balances belonging to the class members." (Pet. App. A36) (emphasis added). Thus, the Appellate Division plainly recognized petitioners' purported distinction between "use" and "benefits from use" and found it unpersuasive.

petitioners sought review by appeal as of right to the New York Court of Appeals. That court dismissed the appeal.[7] (Pet. App. A26). Petitioners then moved for leave to appeal to the New York Court of Appeals, citing the "national importance" of the issues presented. *See* Motion Of Plaintiffs-Appellants For Leave To Appeal To The Court Of Appeals, at 8, in the New York Court of Appeals, Index No. 111667/94. That motion was denied. (Pet. App. A31). Petitioners then filed the instant petition.

REASONS FOR DENYING THE WRIT

This Court should deny the writ because: (i) the court below correctly applied this Court's preemption jurisprudence to the federal regulatory scheme governing free credit balances; (ii) there is substantial uniformity in the lower courts that Section 28(a) of the Securities and Exchange Act of 1934 ("Exchange Act") does not foreclose preemption of state common law claims that conflict with the Exchange Act and SEC regulations; and (iii) the facts of this litigation are unique and unlikely to recur.

---

7. Petitioners represent that "the New York Court of Appeals dismissed the petitioners [sic] appeal as of right on constitutional grounds because — in that court's view — there was *no* constitutional issue." Pet. 3 (emphasis in original). This is a misstatement of the New York Court of Appeals' finding, which was that "no ***substantial*** constitutional question is directly involved." Pet. App. A29 (emphasis added). In light of the New York Court of Appeals' decision less than a year earlier in *Guice* and the similarity of the issues presented in this case, that court properly found that petitioners' grounds for objection to the Appellate Division's finding of preemption were not substantial. *See* Weinstein-Korn-Miller, *New York Civil Practice: CPLR*, ¶ 5601.09, at 56-46 (Matthew Bender 1996) ("Regardless of what the magnitude of a constitutional question might otherwise be, the question is not substantial once the Court [of Appeals] has authoritatively resolved it in a recent decision.").

I.

THE NEW YORK COURTS PROPERLY APPLIED THIS COURT'S PREEMPTION DECISIONS TO THE INTERACTION BETWEEN THE FEDERAL REGULATORY SCHEME GOVERNING FREE CREDIT BALANCES AND PETITIONERS' STATE COMMON LAW CLAIMS.

The petition primarily raises the question of the proper application of this Court's preemption decisions to the interaction of petitioners' state common law claims with the particular federal regulatory scheme at issue. Examination of the regulatory background demonstrates that, under well-settled law, petitioners' claims are preempted.

A. Federal Regulation of Free Credit Balances

1. "Free Credit Balances"

Free credit balances are cash balances in customer brokerage accounts that are payable to customers on demand and that result from securities transactions, deposits of cash including sales of securities, or receipt of dividends or interest. *See* Exchange Act Rule 15c3-3(a)(8), 17 C.F.R. § 240.15c3-3(a)(8) (1996). Because securities accounts are transaction accounts, free credit balances held by a broker-dealer at any given time will represent a fluctuating and complex mass of large and small receipts and disbursements relating to securities transactions and positions.

2. Broker-Dealers' Treatment of Free Credit Balances Is Pervasively Regulated

The handling of customers' free credit balances by securities broker-dealers has been subject to intensive and longstanding oversight and supervision by Congress and the SEC.

a. *Congress*

Congress has determined that the "national public interest" requires a "*national* market system" and a "*national* system for clearance and settlement of securities transactions." Exchange Act, Section 2, 15 U.S.C.A § 78(b) (West 1981) (emphasis supplied). As an integral part of the national regulation of the securities markets, Congress has expressly mandated that the SEC "shall prescribe" rules and regulations regarding "the carrying *and use* of customers' deposits or credit balances." Exchange Act, Section 15(c)(3), 15 U.S.C.A. § 78o(c)(3) (West Supp. 1996) (emphasis supplied). Indeed, Congress has long been aware that free credit balances, which are funds protected by the Securities Investor Protection Act, "may be and are used by broker-dealers to maintain positions in securities, to finance margin purchases of other customers, and to operate their businesses generally" and has recognized that "[o]nly rarely, is interest on [free credit balances] paid by the broker to the customer." H. Rep. No. 91-1613, 91st Cong., 2d Sess. (1970), *reprinted in* 1970 U.S.C.C.A.N. 5254, 5255-56. *See also Matter of Atkeison*, 446 F. Supp. 844, 849 (M.D. Tenn. 1977) (quoting House Report and other Congressional statements).

b. *SEC*

The SEC has complied with the mandate of Congress to regulate broker-dealers' use of customer free credit balances in brokerage accounts by adopting Rules 15c3-2 and 15c3-3 under the Exchange Act. *See* 17 C.F.R. §§ 240.15c3-2 and 240.15c3-3(e) (1996). Rule 15c3-2, adopted in 1964, permits a broker-dealer to use free credit balances in connection with the operation of its business, as long as the broker-dealer informs customers at least quarterly regarding the amount of free credit balances carried for each customer's account, that such funds are *not segregated* and *may be used* in the operation of the

business of the broker-dealer, and that such funds are payable on demand. *See* Exchange Act Rule 15c3-2, 17 C.F.R. § 240.15c3-2 (1996). The SEC rejected a version of this Rule that would have required broker-dealers to disclose whether or not interest would be paid on free credit balances. *Adoption of Rule 15c3-2*, Exchange Act Release No. 34-7325, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,000 at 81,668 (May 27, 1964) ("*Adoption of Rule 15c3-2*").

Rule 15c3-3, adopted in 1972, pursuant to Congress's explicit mandate, expressly authorizes broker-dealers to use free credit balances to finance customer-related activities such as the clearance and settlement of margin transactions, short sales, and failed deliveries. *See* Exchange Act Rule 15c3-3(e), 17 C.F.R. 240.15c3-3(e) (1996) and Exhibit A thereto. In proposing this Rule, the SEC explained that it had engaged in a careful balancing of competing concerns:

> The purpose behind the proposed rules is to afford as complete protection as possible to customers . . . without depriving the industry of *necessary* and *legitimate* means to carry on customer oriented business.

Proposal to Adopt Rules 15c3-3 and 15c3-4 and to Amend Rules 8c-1 and 15c2-1, Exchange Act Release No. 34-9388, 1971 WL 16389, at *6 (Nov. 8, 1971) ("*First Proposal of Rule 15c3-3*") (emphasis supplied). The SEC intended Rule 15c3-3 to be "comprehensive" and uniform in its application. *See Adoption of Rule 15c3-3*, Exchange Act Release No. 34-9856, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,083 at 82,346 (Nov. 13, 1972).

Notwithstanding the fiduciary aura with which petitioners seek to imbue their account relationships with their broker-

dealers, the SEC has explicitly rejected the notion that a broker-dealer acts as a trustee for customer free credit balances.[8] Rather, the SEC has stated that the relationship of broker-dealers to customers with respect to free credit balances is that of *debtor-creditor*. *See Adoption of Rule 15c3-2*, ¶ 77,000 at 81,668; *Proposed Rule 15c3-2*, Exchange Act Release No. 34-7266, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,978 at 81,622 (Mar. 12, 1964) ("*Proposal of Rule 15c3-2*") (the relationship between a broker-dealer and its customer with respect to free credit balances "is that of creditor-debtor"). The SEC has rejected the characterization of free credit balances as "trust funds," explaining that it "sought to avoid freezing the liquid resources of the securities industry or depriving it of business opportunities in areas, such as margin lending, where it has traditionally played a significant and constructive role." *Proposal to Adopt Rule 15c3-3*, No. 34-9622, [1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,801 at 81,729-30 (May 31, 1972) ("*Second Proposal of Rule 15c3-3*").

The SEC has expressly stated that the payment of interest on customers' free credit balances is a matter of contract to be agreed upon between a broker-dealer and its customer, rather than a matter of right. Indeed, it is illegal for broker-dealers to pay interest on free credit balances created for the purpose of earning interest. *See Notice to Broker-Dealers Concerning Interest-Bearing Free Credit Balances*, Exchange Act Release No. 34-18262, 4 Fed. Sec. L. Rep. (CCH) ¶ 25,134B at

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8. As originally proposed, Rule 15c3-3 would have required the segregation of all customer funds in "a 'Special Account for the Exclusive Benefit of Customers' ('the Special Account') *in the nature of a trust fund*," as well as requiring a reserve account. *See First Proposal of Rule 15c3-3*, 1971 WL 16389, at *2-3 (emphasis added). As adopted, the Rule dropped the Special Account requirement and complete segregation in favor of a reserve account requirement.

18,327-3 (Nov. 17, 1981) ("Notice *Concerning Interest*"); *Hon. Frank Horton*, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2027 (Mar. 12, 1983); *In re Newman (Ann)*, SEC No-Action Letter, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,177 at 80,545 (May 6, 1971) (declining to require payment of interest on free credit balances inasmuch as such matters are "governed by contract between the parties") ("*Newman*"); New York Stock Exchange, Inc. ("NYSE") Rule 436, NYSE Guide (CCH) ¶ 2436 (1990).

Long before the SEC's adoption of Rule 15c3-3, the role of free credit balances in enabling broker-dealers to provide services to customers had already been recognized by the SEC in its Special Study of 1963. *SEC, Report of Special Study of Securities Markets*, H. Doc. No. 95, 88th Cong., 1st Sess., Pt. 1, at 393-94 (1963) ("Special Study").[9] In the Special Study, the SEC noted that "[f]ree credit balances come into being in the normal course of the broker-dealers' business" and that "[f]rom the point of view of the broker-dealer, free credit balances represent a *desirable source* of funds since generally they can be *used interest-free* [footnote omitted]." *Id.* at 393, 394-95 (emphasis supplied). The SEC concluded that "rigidly denying broker-dealers the use of such balances would cause *serious dislocation* to a significant part of the securities industry" and that any such denial "would have to be considered in the

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9. The Special Study analyzed the effectiveness of the federal securities laws and regulations and suggested specific recommendations to strengthen public confidence in the securities markets. *See* Special Study at 415. Petitioners take out of context passages from the Special Study, which "recognized the importance of the rules and regulations of *various state and federal* regulatory agencies . . . in providing rights and protection for customers . . ." Pet. 10, n.5 (emphasis in original); Special Study, Ch. III.D.1.d. at 391. This part of the study, however, pertained solely to margin agreements — not to free credit balances. *Id.*

light of its *effect upon the services now provided* by the industry." *Id.* at 401 (emphasis supplied). Such services, which may vary from one firm to another, can include financing and settling customer margin trades and short sales, settling sales where customers fail to deliver the securities sold, maintaining custody of customers' securities, receiving and crediting dividends and interest paid on such securities, and others too numerous to name.

Thus, the SEC, which is charged by Congress with the protection of investors, has extensively regulated the use of free credit balances by broker-dealers. The resulting federal scheme is a carefully balanced one that should not be upset.

B. The New York Courts Properly Applied This Court's Preemption Standards

1. This Court Has Consistently Held That State Laws That Conflict With The Purposes and Objectives of Federal Regulation Are Preempted

The Supremacy Clause preempts petitioners' state law causes of action because they would frustrate the federal regulation of broker-dealer activities in connection with customer free credit balances. *See* U.S. Const., art. VI, cl. 2. Federal preemption of state law can occur in three circumstances: where Congress explicitly preempts state law ("express preemption"), where preemption is implied because Congress has occupied the entire field of law ("field preemption"), and where preemption arises from a conflict between federal and state law ("conflict preemption"). *See Capital Cities Cable Inc. v. Crisp*, 467 U.S. 691, 699 (1984). For there to be conflict preemption, there need not be directly opposing duties between federal and state law that would render compliance with both a literal impossibility. *See Schneidewind v. ANR Pipeline Co.*,

485 U.S. 293, 310 (1988) (preemption may be found even where "collision between the state and federal regulation may not be an inevitable consequence.") (citation omitted); *Securities Indus. Ass'n v. Connolly*, 883 F.2d 1114, 1118 (1st Cir. 1989) ("a direct, facial contradiction between state and federal law is not necessary to catalyze an 'actual[ ] conflict', . . .") (citation omitted), *cert. denied*, 495 U.S. 956 (1990). Instead, an irreconcilable conflict sufficient to give rise to conflict preemption will exist if state law undermines the federal regulatory scheme or when state law "stan[ds] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress" as manifested in the language, structure, and underlying goals of the federal statute at issue. *See Barnett Bank v. Nelson*, 517 U.S. 25, 31 (1996) (citation omitted). Preemption under such circumstances is well-established. *See International Paper Co. v. Ouellete*, 479 U.S. 481, 491-92 (1987); *Hillsborough Co., Florida v. Automated Med. Labs, Inc.*, 471 U.S. 707, 713 (1985).[10]

The doctrine of conflict preemption relates not only to acts of Congress but also to regulations promulgated by federal agencies such as the SEC. *See, e.g., Capital Cities*, 467 U.S. at 699 (Federal Communications Commission). Moreover, state common law, as well as statutes, may be preempted. *See CSX Transportation, Inc. v. Easterwood*, 507 U.S. 658, 675 (1993) (Secretary of Transportation's regulations preempted plaintiff's common law negligence action); *Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 154-55, 159 (1982) (Federal Home Loan Bank Board's due-on-sale regulation

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10. While petitioners make much of caselaw referring to a presumption against preemption of matters of state exercise of local police powers, such as with respect to health and safety, the same concerns are not implicated in state regulation of the national operations of securities firms and their place in the national system for clearance and settlement of securities transactions.

preempted California common law doctrine limiting due-on-sale provisions).

2. Petitioners' State Common Law Claims Conflict With The Purposes and Objectives of The Federal Regulatory Scheme

The SEC, in regulating broker-dealers' use of customer free credit balances, has sanctioned the use of free credit balances by broker-dealers, recognizing that such use does not usually involve payment of interest to the customer but nevertheless has substantial overall benefits for customers and the securities markets. *See Special Study*, at 393-95, 401; *Notice Concerning Interest*, ¶ 25,1348 at 18,327-3; *First Proposal of Rule 15c3-3*, 1971 WL 16389, at *6; *Newman*, ¶ 78,177, at 80,545. The detailed regulation of free credit balances in Rules 15c3-2 and 15c3-3 contains no provision for compensation to customers of any imputed income to broker-dealers from the use of free credit balances; nor does it require segregation of customer funds, as one would expect in a fiduciary relationship. Rather, the regulatory approach relies on specific disclosure requirements, including disclosures that the free credit balances will not be segregated, unlike fiduciary funds, and that the customer's broker-dealer can use these balances in its business. Petitioners do not allege that respondents violated these disclosure requirements.

Instead, petitioners complain that respondents fail to disclose that they "will obtain and retain economic benefits" from the use of customer free credit balances; do not advise customers "of the nature and extent of the economic benefit actually derived" and do not "describe, report or identify what free credit balances are nor the amount of the Plaintiffs' or Class members' free credit balances on hand at any time." (Pet. App. A65-66 at ¶¶ 25-26) (emphasis supplied). Petitioners thus seek additional

disclosure beyond the SEC-mandated disclosure of Rule 15c3-2 — a Rule from which the SEC deliberately deleted any requirement that payment or non-payment of interest be disclosed. The disclosure plaintiffs seek is, therefore, inconsistent with, and thus preempted by, federal law.

This Court found in *Barnett Bank* that state law may not forbid what federal law purposefully permits. In that case, this Court ruled that a federal statute permitting national banks to sell insurance preempts state law to the contrary, stating:

> In this case we must ask whether or not the Federal and State Statutes are in "irreconcilable conflict." The two statutes do not impose directly conflicting duties on national banks — as they would, for example, if the federal law said, "you must sell insurance," while the state law said, "you may not." Nonetheless, *the Federal Statute authorizes national banks to engage in activities that the State Statute expressly forbids. Thus, the State's prohibition of those activities would seem to "stand as an obstacle to the accomplishment" of one of the Federal Statute's purposes. . . .*

Id. at 31 (emphasis supplied). *Accord Capital Cities*, 467 U.S. at 699 (striking state law forbidding cable companies from broadcasting federally-permitted liquor advertisements). This Court's reasoning in *Barnett Bank* is applicable to this action. Since being given authority by Congress to regulate the treatment of customer free credit balances more than two decades ago, the SEC has not only permitted the present treatment by broker-dealers of free credit balances, it has specified, in Rule 15c3-2, the disclosure that must be made to the customer with respect to these balances. As discussed above, the SEC has chosen not to require that all or part of any benefit obtained from broker-

dealers' use of customer free credit balances inure to those customers. Indeed, the SEC deliberately rejected the treatment of free credit balances as trust funds. *See Second Proposal of Rule 15c3-3*, ¶ 78,801 at 81,729-30; *Adoption of Rule 15c3-2*, ¶ 77,000 at 81,668 (May 27, 1964); *Proposal of Rule 15c3-2*, ¶ 76,978 at 81,622. This regulatory choice may not be overridden by state common law. *See Edgar v. MITE Corp.*, 457 U.S. 624, 635 (1982) (plurality found conflict preemption where federal requirements like those of state law had been considered but rejected).

Further, application of state law to the treatment of free credit balances by broker-dealers would unduly encroach upon the balance of interests struck by Congress and the SEC in regulating that practice. *See Edgar*, 457 U.S. at 634, 639 (plurality found that state anti-takeover statute upset congressional balancing of management's and shareholders' interests by favoring the former). The SEC has attempted to provide, so much as possible, "virtually complete customer protection" while not "depriving the industry of necessary and legitimate means to carry on customer oriented business." *First Proposal of Rule 15c3-3*, 1971 WL 16389, at *6.

Petitioners cite *Freightliner Corp. v. Myrick*, 514 U.S. 280, 282 (1995), for the proposition that "the absence of a federal standard cannot implicitly extinguish state common law." Pet. 13. In *Freightliner*, the defendants claimed that certain regulations of the National Highway Traffic Safety Administration ("NHTSA") concerning air brakes preempted the petitioners' state law negligent design claims. The Ninth Circuit, however, had previously enjoined NHTSA from enforcing those regulations, citing the agency's failure to show sufficient evidence to justify its regulations. *See Paccar, Inc. v. NHTSA*, 573 F.2d 632, 640-43 (9th Cir.), *cert. denied*, 439 U.S. 862 (1978). Accordingly, this Court found that the lack

of federal regulation did not result from any affirmative decision by the agency not to regulate, but from a federal court order. *Id.* at 286-87. Unlike the NHTSA in *Freightliner*, however, the SEC has extensively studied and specifically rejected the requirement that broker-dealers treat free credit balances as trust funds. Accordingly, the SEC's decision is a carefully considered federal standard that extinguishes all inconsistent state common law causes of action.

Even if characterized solely as a decision not to regulate, a decision by a federal agency to take a "hands-off" approach does not serve as a signal to a state that it may regulate. *See Ray v. Atlantic Richfield Co.*, 435 U.S. 151, 178 (1987) (" 'where failure of . . . federal officials affirmatively to exercise their full authority takes on the character of a ruling that no such regulation is appropriate or approved pursuant to the policy of the statute,' [s]tates are not permitted to use their police power to enact such a regulation.") (quotation and citation omitted); *Carstensen v. Brunswick Corp.*, 49 F.3d 430, 431 (8th Cir.) ("The decision not to regulate has the same preemptive force as a decision to regulate."), *cert. denied*, 516 U.S. 866 (1995); *Pokorny v. Ford Motor Co.*, 902 F.2d 1116, 1123 (3d Cir.) (finding preemption of state defective design claim where less restrictive federal automobile safety regulation was intended to preserve industry flexibility and customer choice), *cert. denied*, 498 U.S. 853 (1990).[11]

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11. Petitioners also cite this Court's recent decision in *Medtronic v. Lohr*, 518 U.S. 470, 116 S. Ct. 2240 (1996), for the proposition that "substantially identical state and federal standards of behavior or performance [do not] preempt state causes of action." Pet. 13. Petitioners concede, however, that the obligations they seek to impose are not "substantially identical" to the federal scheme. *Id.* Moreover, the decision in *Medtronic* turned upon the meaning of a statutory term — "requirements" — that is not at issue here. *See Medtronic*, 518 U.S. at ___, 116 S. Ct. at 2255-59.

In sum, by asking that respondents' treatment of free credit balances be subjected to greater obligations under state law than under federal regulation, petitioners would have state courts eviscerate the SEC's carefully drawn regulatory scheme. The New York courts properly found that the Supremacy Clause does not permit this.[12]

II.

THERE IS NO CONFLICT BETWEEN THE LEGISLATIVE PURPOSE OF SECTION 28(a) OF THE EXCHANGE ACT AND THE LOWER COURTS' FINDING THAT PETITIONERS' CLAIMS ARE PREEMPTED.

Petitioners rely upon the "Savings Clause" of the Exchange Act, Section 28(a), to posit a "conflict" that needs to be resolved by this Court. They argue that the lower courts in this action "failed to consider" that Section 28(a) provides that "the Exchange Act's rights and remedies are 'in addition to any and all other rights and remedies that may exist a law or in equity.' " Pet. 11. In fact, the Section 28(a) argument was presented to the Appellate Division in extensive briefing and at oral argument, and rejected.[13] The New York Court of Appeals then

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12. For purposes of opposing the petition for a writ of certiorari, respondents will not fully address the alternative grounds raised below for dismissal. As argued below, however, the complaint should also be dismissed under the Commerce Clause of the Constitution and pursuant to the principles of primary jurisdiction. Moreover, as discussed, *infra*, Point III, there is no merit to petitioners' state law claim.

13. *See* Brief For Defendants-Appellants, at 25-26, n.15, Brief For Plaintiffs-Respondents, at 14-16; and Reply Brief For Defendants-Appellants, at 14-16, all in the Appellate Division, Index No. 111667/94.

refused to grant leave to appeal that decision. (Pet. App. A31). Moreover, as petitioners fail to mention, numerous courts have addressed this issue in recent years, primarily in the context of challenges to the practice known as "payment for order flow." In every such action in which the merits have been addressed, the courts have ultimately found in favor of preemption.

In any event, petitioners' argument is without merit. Conflict preemption has been found by this Court despite the existence of savings clauses in federal statutes. For example, this Court held that Vermont's common law cause of action for nuisance against a water pollution source in New York was preempted by the Clean Water Act, despite the Act's savings clause, which provided that "nothing. . . shall restrict any right which any person . . . may have under any . . . common law . . . to seek any other relief." *International Paper Co. v. Ouellette*, 479 U.S. 481 (1987). This Court found that permitting the law of a state in which the pollution source was not located to impose a "separate discharge standard . . . would be a serious interference with the achievement of the 'full purposes and objectives of Congress.' " *Ouellette*, 479 U.S. at 493. This Court concluded that "[i]t is unlikely — to say the least — that Congress intended to establish such a chaotic regulatory structure." *Id.* at 497. *See also Michigan Canners & Freezers Ass'n v. Agricultural Marketing and Bargaining Bd.*, 467 U.S. 461 (1984) (Michigan statute preempted by Agricultural Fair Practices Act because of conflict between the Michigan statute and that Act, despite a savings clause similar to Section 28(a)).

Similarly, a plurality of this Court has determined that Section 28(a) did not foreclose conflict preemption but "left the determination [of preemption] . . . to the courts." *Edgar*, 457 U.S. at 631. Thus, as the New York Court of Appeals found in *Guice*, Section 28(a) negates a finding of "field" preemption, but it does not alter the conflict preemption analysis.

Guice, 89 N.Y. 2d at 49-50, 674 N.E. 2d at 291-92, 652 N.Y.S. 2d at 361-62. The Appellate Division properly recognized that such reasoning applies with equal force to petitioners' argument that Section 28(a) expressly preserves their claims. After considering this argument and the New York Court of Appeals' unanimous holding in *Guice*, the Appellate Division decided that this action was controlled by *Guice*. (Pet. App. A37).

Petitioners do not challenge the holding of *Guice*. Rather, petitioners dispute that *Guice* is similar to this action, Pet. 16-17 & n. 6, an argument expressly rejected by the Appellate Division and implicitly rejected by the New York Court of Appeals when it determined that no substantial constitutional issue was directly presented in petitioners' unsuccessful effort to appeal to that court. (Pet. App. A26). *Guice* involved state common law claims relating to "payments for order flow", *i.e.*, allegedly undisclosed benefits obtained by broker-dealers in connection with execution of orders for customer accounts. Payments for order flow are the subject of SEC rules that require disclosure of payment for order flow practices on customer confirmations and account statements, as well as upon opening new accounts. *See Guice*, 89 N.Y. 2d at 39-43, 674 N.E. 2d at 286-88, 651 N.Y.S. 2d at 356-58. Although these regulations specify how and when information about brokers' receipt of payments for order flow is to be disclosed to customers, the SEC has refused either to ban the practice or to require brokers to pass the benefits of payments for order flow along to their customers. In light of this regulatory history, the New York Court of Appeals held that state law causes of action against two defendant broker-dealers for, *inter alia*, breach of fiduciary duty were preempted by the Supremacy Clause because they conflicted with federal law. The court reasoned:

> Permitting the courts of each State to impose civil liability on national securities brokerage firms . . .

> for failure to meet more stringent common-law agency standards of disclosure of receipt of order flow payments . . . would inevitably defeat that congressional purpose of enabling the SEC to develop and police that "coherent regulatory structure" for a national market system. Securities broker-dealers, confronted with the risk of nation-wide class action civil damage liability, including restitution of commissions and punitive damages . . . would be impelled to tailor their disclosures to each State's common law agency jurisprudence, and the carefully-crafted SEC disclosure requirements would have little, if any, influence. Surely "[i]t is unlikely — to say the least — that Congress intended to establish such a chaotic regulatory structure . . ."
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> * * *
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> When, thus, a State's regulation, through the imposition of common-law tort liability or otherwise, adversely affects the ability of a Federal administrative agency to regulate comprehensively and with uniformity in accordance with the objectives of Congress, "then the state law may be pre-empted even though 'collision between the state and federal regulation may not be an inevitable consequence . . .' "

Guice, 89 N.Y. 2d at 46-47, 674 N.E. 2d at 290, 651 N.Y.S. 2d at 360 (citations and footnote omitted). This Court declined to review the New York Court of Appeals' decision. 117 S. Ct. 1250 (1997).[14]

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14. Petitioners claim that the order flow decisions do not control the result here because the order flow payments involved in

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The issues raised in this case are, in all material respects, virtually identical to those addressed in *Guice*. Here, as in *Guice*, the plaintiffs assert that defendant broker-dealers obtained unaccounted-for benefits from plaintiff's' securities accounts, which they did not pass along to their customers, allegedly in violation of state common law duties. Here, as in *Guice*, the claims purportedly extend to a nationwide class of plaintiffs and would effectively require all broker-dealers to conform their nationwide operations to state law standards. Here, as in *Guice*, the complaints seek monetary relief for the asserted breaches of fiduciary duty. Here, as in *Guice*, the complaint asserts claims based upon nondisclosure of matters of which the SEC does not mandate disclosure. *Compare Guice*, 89 N.Y. 2d at 38-39, 674 N.E. 2d at 285, 651 N.Y.S. 2d at 355 *with* Pet. App. A65-66 at ¶ 25-26. Here, as in *Guice*, the SEC has not prohibited the challenged practice but has sought to balance conflicting policy concerns by regulations through disclosure and other requirements. *See First Proposal of Rule 15c3-3*, 1971 WL 16389, at *6. Here, as in *Guice*, conformance to one or more state law standards would moot the SEC regulations by suppressing a practice explicitly found by the SEC to have important benefits to customers. *See Special Study*, at 393-401. Finally, here, as in *Guice*, the SEC has extensively studied and consistently adhered to its regulatory approach. Its regulation has, from the start, been premised on its finding that the

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those cases, unlike free credit balances, have been the subject of extensive study by the SEC. Pet. 16. This contention is rebutted by the legislative and regulatory history discussed earlier in this brief, establishing that both the SEC and Congress carefully studied, recognized the benefits of, and approved the use of free credit balances by broker-dealers without payments to customers. Moreover, under section 15(c)(3) of the Exchange Act, the SEC possesses pervasive authority to monitor the use of free credit balances by broker-dealers.

relationship of broker to customer in the handling of customer free credit balances is one of debtor-creditor, and thus the payment of interest on such balances is a matter of contract, not a matter of right. *See supra,* Point I.

Moreover, *Guice* stands as part of a consistent line of cases finding that the federal securities laws preempt certain state common law claims against broker-dealers where those claims are based on state law that is more restrictive than the carefully considered federal regulatory scheme. *See, e.g., Dumont v. Charles Schwab & Co.*, Nos. 96-C-2685 & 97-CA-1225 (La. Ct. App. 4th Cir. Apr. 8, 1998); *Orman v. Charles Schwab & Co.*, 688 N.E. 2d 620, 621, 625-26 (Ill. 1997), *petition for cert. filed* (Feb. 18, 1998) (No. 97-1367); *Shulick v. Paine Webber, Inc.*, 700 A.2d 534, 536, 538 (Pa. Super. Ct. 1997); *Eirman v. Olde Discount Corp.*, 697 So. 2d 865, 866 (Fla. Dist. Ct. App.), *certification denied*, (Fla. Aug. 28, 1997); *Dahl v. Charles Schwab & Co.*, 545 N.W. 2d 918 (Minn.), *cert. denied*, 117 S. Ct. 176 (1996).

III.

THE FACTS OF THIS LITIGATION ARE UNIQUE AND UNLIKELY TO RECUR.

Petitioners' claim that this case is of such great importance as to warrant this Court's review ignores the limited scope of the conflict in issue. The SEC's regulation of free credit balances preempts only a narrow subset of state law claims. The unimportance of these claims is borne out by the fact that only one other state court case has presented a conflict between the purported state law obligations of broker-dealers in handling free credit balances and the federal regulatory scheme and that case has been dismissed without appeal. *See In Re Prudential Secs., Inc. Sweep Litigation*, No. 122747/95 (N.Y. Sup. Ct.

N.Y. Cty. Jun. 24, 1997). (Resp. App. 20a).[15] And, petitioners' claims are in any event without merit.[16] Moreover, as noted

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15. Thus, certiorari should also be denied because the particular conflict between state and federal law presented by this case is unlikely to recur. It is entirely possible that, once this litigation is concluded, this issue will not be presented to any court any time soon. The progress of this litigation demonstrates why. Petitioners brought suit against eleven of the largest firms in the securities industry. As noted above, the class they sought to represent was inherently unwieldy and tremendously diverse in interests, and the particular practices at issue varied greatly by time, individual defendant, and type of transaction and account. The trial court's October 2, 1996 opinion denying the motion for class certification left grave doubts as to whether, under these circumstances, such a class could ever be certified. (Resp. App. 1a). Petitioners' claims would require the factfinder to unravel, at a minimum, virtually every securities transaction in petitioners' accounts throughout the applicable limitations period. Furthermore, as discussed below, there is no state law duty to pay interest or any other compensation for use of free credit balances; the relationship between a brokerage firm and its customers, when they choose to leave funds idle in their accounts, is that of debtor-creditor.

16. Petitioners' theory that a fiduciary relationship is created whenever a broker-dealer handles customer funds directly conflicts with controlling authority in New York regarding the limited circumstances in which broker-dealers owe fiduciary duties to their customers. Because almost every aspect of the ordinary customer-broker business involves the handling of customer assets, if petitioners' position were correct, a broker-dealer necessarily would owe a fiduciary duty to its customer virtually at all times. This is not the law; the New York courts have held that "a broker does not, in the ordinary course of business, owe a fiduciary duty" to a customer. *See, e.g., Perl v. Smith Barney Inc.*, 230 A.D.2d 664, 666, 646 N.Y.S.2d 678, 680 (N.Y.A.D. 1st Dep't), *appeal denied*, 89 N.Y.2d 803, 675 N.E.2d 1234, 653 N.Y.S.2d 281 (N.Y. 1996); *Fekety v. Gruntal & Co.*,

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above, the broader issue — the impact of Section 28(a) on state law claims that conflict with the Exchange Act — has been resolved with substantial uniformity by the lower courts. *See supra* Point II. Finally, the practices of which petitioners complain are of decreasing practical importance. Competition in the brokerage industry has increasingly led respondents and other broker-dealers to offer "sweep" accounts in which free credit balances are automatically invested in money market funds. Thus, the free market has provided a response, bearing out the wisdom of the SEC's insistence that payment of interest on free credit balances is "governed by contract between the parties." *Newman*, ¶ 78,177, at 80,545.

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191 A.D. 2d 370, 371, 595 N.Y.S.2d 190, 190-91 (N.Y.A.D. 1st Dep't 1993). *See also Press v. Chemical Inv. Servs.*, No. 96 Civ. 8331, 1997 WL 795100, *8-10 (S.D.N.Y. Dec. 22, 1997), and cases cited therein. This is consonant with "[t]he general [common law] rule . . . that a broker is not the fiduciary of his customer unless the customer entrusts him with discretion to select the customer's investments" *Carr v. CIGNA Secs.*, 95 F.3d 544, 547 (7th Cir. 1996) (Posner, C.J.). Similarly, petitioners' unjust enrichment theory is fatally flawed. The right to use funds (which petitioners do not challenge, *see* Pet. 2-3) implies the right to retain the earnings thereon, unless otherwise agreed. *See, e.g., Surrey Strathmore Corp. v. Dollar Sav. Bank*, 36 N.Y.2d 173, 177, 325 N.E.2d 527, 529-30, 366 N.Y.S.2d 107, 110-11 (1975) (permitting bank to retain benefits earned from using customer funds inasmuch as bank was authorized to use funds). Moreover, petitioners have not pleaded, nor can they, that any enrichment of respondents was at the "expense" of petitioners, *i.e.*, that any plaintiff has demanded access to his or her free credit balance and that the demand was rejected.

CONCLUSION

For the foregoing reasons, respondents respectfully request that this Court deny the petition for certiorari.

Respectfully submitted,

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April 10, 1998

APPENDIX A — MOTION AND MEMORANDUM OPINION OF THE SUPREME COURT OF THE STATE OF NEW YORK, NEW YORK COUNTY FILED OCTOBER 2, 1996

SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PRESENT: **Hon.** Charles E. Ramos **Part 53**
Justice

INDEX NO. 111667/94

MOTION DATE 7/30/96

MOTION SEQ. NO. 006

MOTION CAL. NO. 01

ESTATE OF DAVID J. BRAUNSTEIN, et al.

- v -

MERRILL LYNCH, PIERE, FENNER & SMITH, Inc., et al.

* * *

Cross-Motion: ☐ **Yes** ☑ **No**

Upon the foregoing papers, it is ordered that this motion for class certification is decided in accordance with the annexed memorandum.

Dated: 9/26/96

s/ Charles E. Ramos
J.S.C.

Appendix A

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: COMMERCIAL DIVISION

THE ESTATE OF DAVID J. BRAUNSTEIN and ROSEMARIE BRAUNSTEIN, et al.,

Plaintiffs,

- against -

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED et al.,

Defendants.

CHARLES E. RAMOS, J:

This is an action by the customers of several major securities brokerage firms, challenging the control and use of "free credit balances" on their customers' investment accounts. Plaintiffs move, pursuant to CPLR §§ 901 and 902, for an order to certify the class action on their claims for common law breach of fiduciary duty and unjust enrichment.

THE FACTS

Plaintiffs are twelve Arizona residents[1] and customers of the defendants which do business or are headquartered in New York. Plaintiffs seek to represent a class consisting of:

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1. Several of the named plaintiffs originally filed this litigation in Arizona Superior Court on July 12, 1993. The case was then stayed on forum non convenience grounds by order dated November 1, 1993, in which the court held that New York was a more appropriate

(Cont'd)

Appendix A

> All persons or entities who have, or have had accounts with one or more of the defendants in which they have had free credit balances which existed overnight or longer from which the defendants have received economic benefits for which the defendants have not properly accounted to the plaintiffs. Excluded from the class are the defendants, all employees of the defendants and the members of their immediate families, the subsidiaries and affiliates of the defendants, any trusts of any entities which they control or of which they are the beneficiaries and the heirs, successors or assigns of any of the defendants.

(First Amended Complaint at p. 9). Free credit balances are cash balances in a customer's account which are otherwise unencumbered, and are subject to immediate cash payment to a customer on demand. Generally, they result from sales of securities, dividends, interest, or transfers of account balances from one broker to another, and may exist overnight or longer depending upon the type of transaction involved. Defendants use these balances to make loans to other customers at allegedly relatively high interest rates. At issue is whether defendants can profit from such use without paying to their customers any portion of the profits earned on the use of the customer's funds.

On June 7, 1995, Justice Walter Schackman of this court dismissed the complaint without prejudice for failure to plead a

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(Cont'd)
forum for the litigation. Further holding that "[s]hould the New York court impose any substantial impediment to or limitation upon that litigation which this court would not impose," the court would consider vacating the stay and denying the defendants' motion to dismiss. (Plaintiffs' Notice of Motion, Second Ex. A, p.8).

breach of fiduciary duty and unjust enrichment with the requisite particularity under CPLR § 3016(b). In his ruling, he found that broker-dealers are permitted to use free credit balances for their own purposes, under Securities Exchange Rule 15c3-2 and 15c3-3, and that "to the extent that the balances are thus used, they are not being misused; there has been no breach of trust." (J. Schackman's Order, 6/7/95 at p. 3).

Plaintiffs then served the amended complaint which alleges that the defendants have adopted methods and procedures to use free credit balances which have been unnecessarily created or left in customers' accounts for longer periods than necessary. It further alleges that defendants have failed to adequately disclose, or account to plaintiffs for profits earned from the use of their balances. Plaintiffs seek restitution of any profit earned by defendants, an accounting, and injunctive relief.

The amended complaint was upheld by Justice Schackman in his order dated May 7, 1996. Therein, he states that: "the relationship between a stockbroker and its customer . . . is that of principal and agent and, thus, is fiduciary in nature." In quoting *Greenwald v. Shearson Lehman Brothers, Inc.*, (NYLJ, Nov 4, 1993, at 22, col.3 [Sup Ct, NY County]), he also states that:

> Whenever the broker is acting as the agent of the customer, for example, in executing a customer's order or handling customer funds, the customer has the right to assume and to rely on the fact that the broker is acting for his or her benefit at all times during the relationship. (Cite omitted).

(Decision, at p. 3; citing *Evangelist v. Fidelity Brokerage Services, Inc.*, __ AD2d __, 637 NYS2d 392 [1st Dept 1996]

Appendix A

[reversing dismissal of class action complaint against securities broker alleging breach of fiduciary duty resulting from failure to disclose practice of receiving order flow payments from market makers as inducement for placing orders with them]; *Feinberg v. Dean Witter Reynolds*, Sup Ct, NY County, August 14, 1992, Arber, J., Index No. 11868/92 [fiduciary duty may exist regarding undisclosed $50 service charge on brokerage accounts]).

CPLR ARTICLE 9

Under CPLR § 901(a), one or more members of a class may sue or be sued as representative parties on behalf of all if:

1) the class is so numerous that joinder of all members, whether otherwise required or permitted, is impracticable;

2) there are questions of law or fact common to the class which predominate over any question affecting only individual members;

3) the claims or defenses of the representative parties are typical of the claims or defenses of the class;

4) the representative parties will fairly and adequately protect the interest of the class; and

5) a class action is superior to other available methods for the fair and efficient adjudication of the controversy.

Appendix A

The goal of the class action device is to "achieve economics of time, effort, and expense, and promote uniformity of decision as to persons similarly situated". (*Sanders v. Robinson Humphrey/American Express, Inc.*, 634 F Supp 1048, 1054; *Friar v. Vanguard Holding Corp.*, 78 AD2d 83, 91 [2nd Dept. 1980]). The movant bears the burden of proving that all of the prerequisites of CPLR § 90 (a) have been met, which must be shown by offering more than mere conclusory allegations. (*Katz v. NVF*, 100 AD2d 470, [1st Dept. 1984]; *Brandon v. Chefetz*, 121 Misc.2d 54, 56 [1st Dept 1983]). It is not until all of the prerequisites of § 901 (a) have been met that the court can consider CPLR § 902 which sets forth five illustrative guidelines for the court to determine the viability of a class action. Whether, or not, to certify a class is within the court's discretion. However, the statute should be liberally construed, since the state's policy is in favor of maintenance of class actions. (*Brandon v. Chefetz*, 106 AD2d 162 [1st Dept. 1985]). Because Article 9 of the CPLR is modeled on Rule 23 of the Federal Rules of Civil Procedure, New York courts have looked to interpretations of Rule 23 for guidance. (*Stern v. Carter*, 82 AD2d 321 [2nd Dept 1978]; 2 Weinstein-Korn-Miller, NY Civ Prac ¶ 901.02).

FINDINGS

In applying the criteria of CPLR § 901(a), the court finds that while the class is sufficiently numerous, class action is not currently warranted. Because plaintiffs have not shown a common course of conduct in the mishandling of accounts, class certification must be denied as to this aspect of the complaint. Breach of a duty to disclose and the claim for unjust enrichment are commonly based upon similar facts. However, under the remaining criteria, plaintiffs have failed to demonstrate that there are common issues of law, a typicality of claims and

practices of the various defendants that allegedly give rise to those claims, and that the plaintiffs can adequately represent the class. On this record, the court also cannot find that a class action is a superior method, and therefore, the motion for class certification is denied without prejudice to renew.

DISCUSSION

The number of potential class members in this proposed nation-wide class action lies somewhere in the millions. Plaintiffs need not specify an exact number of class members, but must show only that joinder is impracticable through "some evidence or reasonable estimate of the number of purported class members." (*Zeidman v. J. Ray McDermott & Co.*, 651 F2d 1030, 1038 [5th Cir. 1981]). Defendants have indicated that they maintained a total of approximately 23,600,000 accounts, in 1993, on which approximately 1,170,000 transfers occurred. None of them contend that the plaintiffs have not met the numerosity requirement, and thus, this court finds that the first prerequisite of CPLR § 901(a) has been satisfied.

Defendants essentially oppose class certification on the grounds that common questions do not predominate. They allege that a trial will require examination of: each of the defendants' various types of customer accounts; the policies and procedures of each defendant for handling their accounts; the various type of transactions creating free credit balances; the identity of those portions actually used; the timing of the availability of each free credit balance; and the amount by which each defendant has benefitted. (Def. Memo. p. 24-32).

Defendants also contend that common issues do not predominate because individual issues will be raised since class

members reside throughout the United States and in some foreign jurisdictions, and thus, the court will have to apply the laws of all fifty states. Some customers have signed account customer agreements which contain choice of law provisons. Defendants allege that the court will have to apply the laws of at least three states, and perform a conflict of laws analysis for those class members who have not signed an agreement. Thus, they conclude that a case of this magnitude is unmanageable, and therefore, class certification should be denied.

Commonality is established, under CPLR § 901 (a) (2), when the activity complained of involves one set of operative facts from which plaintiffs' claims arise. (*Green v. Wolf*, 406 F2d 291, 299-300 [2d Cir. 1968], *cert denied*, 395 US 977 [1969]; *Friar v. Vanguard Holding Corp.*, *supra* 78 AD2d at 99). "It is unnecessary that every question be common to each member of the class; all that is required is that common questions predominate over individual ones." (*Gilman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 93 Misc.2d 941, 947 [Sup. Ct. NY County 1978]). Generally, the courts focus on the liability issue in deciding whether the predominance requirement has been met, and if the liability issue is common to the class, common questions are held to predominate over individual questions. (*Dura-Bilt Corp. v. Chase Manhattan Corp.*, 89 FRD 87, 93 [SD NY 1981] *citing, Sargent v. Genesco Inc.*, 75 FRD 79 [M.D. Fla. 1977]; *Brady v. Lac Inc.*, 72 FRD 22 [SD NY 1976]).

Some courts have held that commonality is satisfied when the plaintiffs' complaint centers on the defendants having engaged in a common course of conduct, or a common core of facts which clearly links the class members to the resolution of the litigation even though the individuals are not identically

situated. (Weinstein-Korn-Miller, NY Civ Prac ¶ 901.11). On this basis, commonality can be inferred until it is proven at trial that the plaintiffs and all class member are similarly situated. (*See, Brandon v. Chefetz, supra* 106 AD2d at 167 [granting class certification where defendant participated in a common scheme by using long term compensation agreements to misappropriate portions of the shareholders' profits]; *Stellema v. Vantage Press, Inc*, 121 Misc.2d 1058 [Sup Ct NY County 1983], *aff'd in part, mfd in part*, 109 AD2d 423 [1st Dept 1985] [finding the representations were uniform and generally transmitted in two documents]; *Green v. Wolf Corporation, supra* 406 F2d 291 [granting class certification where the defendants' misrepresentations in three prospectuses comprised a common course of conduct]; *In re Lilco Securities Litigation*, 111 FRD 663 [ED NY 1986] [finding a common course of conduct after defendants failed to disclose material information in written documents "addressed to the class as a whole[.]"; *Vulcan Society of Westchester County v. Fire Dept. Of City of White Plains*, 82 FRD 379 [SD NY 1979] [finding four defendant municipalities had engaged in a common course of conduct by using the same written examination purportedly to further their discriminatory hiring practices]; *Roberts v. Heim*, 670 F Supp 1466 [ND Cal 1987], *aff'd in part mdfd in part*, 857 F2d 646 [finding a course of conduct based upon an alleged conspiracy]).

Some courts, however, have declined to find a common course of conduct. (*See, Sanders v. Robinson Humphrey/ American Express, Inc., supra*, 634 F.Supp 1048 [ND Ga 1986] [finding that there was no proof of a uniform "sale pitch" by the defendants to all the members of the proposed classes]; *In re Scientific Control Corp. Securities Lit.*, 80 FRD 237 [SD NY 1978] [rejecting, as against certain defendants, allegations of a common course of conduct where there was no proof that

they used misleading written financial statements]; *Evans v. City of Johnstown*, 97 AD2d 1 [3d Dept 1983] [denying class action for personal injury claims arising from operation of sewage plant because individual issues of causation and damages are particular to each plaintiff]; *See, also Castano v. American Tobacco Company*, 84 F3d 734 [5th Cir 1996] and *In re American Medical Systems, Inc.*, 75 F3d 1069 [6th Cir 1996] [no common course of conduct in mass products liability or negligence cases because proof will vary from plaintiff to plaintiff on the issue of causation.])

Two distinct breaches of fiduciary duty have been alleged in the complaint: 1) a failure to disclose, and 2) a mishandling of customers' accounts. (Amended Complaint, p. 12 at ¶ 20). A common course of conduct in breach of a duty to disclose will, if proven at trial, support all of the class members' claims. However, no common core set of facts have been shown which would support the allegation that all accounts have been similarly mishandled.

Regardless of the type of account, no lesser duty is owed to a stockbroker's customer than the duty to disclose any material information regarding the account (*See, Richardson v. Shaw* 209 US 365 [1908]). Once a transaction is made and until its completion, or where there has been a reposing of trust, the same duty is owed to all account holders. (*See, Le Marchant v. Moore*, 150 NY 209 [1896]; *Hopkins v. Clarke*, 158 NY 299 [1899]). Plaintiffs have alleged that each defendant unilaterally controls a customer's free credit balances, and therefore, all customers have reposed a similar type of trust. On this issue, defendants have not shown that individual questions predominate, because, arguably, a duty may attach to any customer's account where a free credit balance exists. For

example, if free credit balances are found to occur prior to the end of a transaction, or are within a broker's exclusive control, it may be found a duty is owed until the transaction is complete, and until the balance is no longer "free". Therefore, proof of a duty to disclose need not depend on individual facts particular to each class members' account.

Similar to the cases cited above, common questions will predominate on this issue because each member may have claims against the defendants for omitting this information from their customers' written account statements. In breach of their duty, plaintiffs have alleged that each defendant sends to all customers an account statement which fails to disclose the dollar amount of existing free credit balances, and that their customers will not receive any of the benefits earned. (Amended Complaint, p. 14 at ¶ 24). Although defendants admit that a customer has a right to withdraw their free credit balances on demand, it has been asserted that "a client [can] not tell specifically [from the account statements] whether his balance is a free credit balance or not". (Dolan Deposition, at p. 38 [2]-41[13]). Thus, the wrong complained of may be identical for each of the class members. Similarly, the several defenses that have been raised are available against all class members.

This court is unpersuaded by defendants' contention that plaintiffs will have to prove that each class member lacks knowledge of the "longstanding industry-wide practice" not to pay customers part the benefits earned. Because the members' claims are based upon the failure to disclose the amount of the balances, the defendants, not the plaintiffs, may be required to prove that adequate notice was given. The defendants' assertion that a notice appearing on the reverse-side of the account statements adequately discloses to the customer "the right to

use" and "the customers' right to withdraw such balances on demand" is dispositive on this issue is premature. (Def. Memo. p. 28 and 39). They argue individual issues will predominate in raising their defenses because notice, waiver, and estoppel all require proof that each class members knew about the use of the balances, knowingly relinquished their right to any benefits earned, and thereby, caused them to rely upon a customer's actual or implied consent. While certain class members may be more sophisticated or knowledgeable than others about the use of free credit balances, those facts are not so particular to individual class members that subclasses cannot be created to address this problem. Inferences can be drawn from the defendants' written notice, therefore, it may be implied, as to certain class members, that they knew or should have known about the use of free credit balances. (*Derenco, Inc. v. Benj. Franklin Federal Savings & Loan Assn., supra* 577 P.2d 477 [Sup Ct Oregon, 1977]). Whatever differences do exist with regard to actual knowledge, these can be proven at the same time as individual damages are proven. (*Compare, Stellema v. Vantage Press, supra* 109 AD2d at 426). Thus, this is not a basis for denying class certification on the issue of liability. (*Ray v. Marine Midland Grace Trust,* 35 NY2d 146, 154 [1974]; *Dura-Bilt Corp. v. Chase Manhattan Corp., supra*, 89 FRD 87 [SD NY 1981]).

Based upon these allegations, it may or may not be found that plaintiffs have a quasi-contract right to an accounting for the benefits earned. The circumstances surrounding the parties' relationship will no doubt encompass a duty to disclose, and if the failure to disclose is found to unjustly enrich the defendants, then plaintiffs and the class members may be entitled to equitable or monetary relief. (*See, Derenco, Inc. v. Benj. Franklin Federal Savings & Loan Assn., supra* 577 P.2d 477 [Sup Ct Oregon, 1977]).

Appendix A

On the question of damages, individual issues clearly predominate over common issues. Since if damages are found, a determination may depend upon the amount of free credit balances existing on an account, whether the balances were used, or the members' type of account. However, this is no reason to deny class certification because under such circumstances the court has the authority to order a bifurcated trial with respect to liability and damages. (*Friar v. Vanguard Holding Corp., supra* 78 AD2d at 99).

As to the second aspect of the claim for breach of duty, plaintiffs have failed to show that a *common* "method and procedure" was adopted by the defendants whereby free credit balances were unnecessarily created, delayed or retained. (Amended Complaint, p. 12 at ¶ 20). Each of the eleven defendants' policies and procedures for handling its customers' accounts will have to be examined in order for plaintiffs to prove their claim. By their very nature, no two free credit balances appear to be the same, and they can be created through any number of methods. Whether or not they were improperly handled by defendants will depend on proof that each type account imposes a similar duty, and that each type of transaction free credit balances were unlawfully retained on a customer's account. On each type, it will have to be proven that a free credit balance existing overnight or longer has been unnecessary delayed or retained.

There is no common overriding standard or common set of facts which will allow this determination to be made other than on a case by case basis, and this court cannot envision how separate individualized trials will not ensue. Plaintiffs do not propose how they plan to manage a trial on this aspect of their claims. Their conclusory statement that subclasses may be

created, ignores the very real possibility that a trial on this issue is likely to splinter into separate "mini-trials" in hope of resolving these individual issues. Therefore, the court finds that separate trials must be had, since class certification is not appropriate as to this aspect of members' claims.

On the questions of law, plaintiffs allege that this court should not focus on the class and their contacts to this and other states because New York law will apply to all class members' claims based upon defendants contacts to New York, and this state's interest in the securities industry. The parties also dispute who should bear the burden of showing whether significant differences exist in the substantive law of the several states.

In *Phillips Petroleum Co. v. Shutts*, (472 US 797 [1985]) the Supreme Court held that Kansas could not apply its own law in a nationwide class action involving a failure to make royalty payments on natural gas leases. The leased land was located in eleven states and the three named plaintiffs resided in Kansas or Oklahoma and owned leases in Texas and Oklahoma. The Court held that a state court "may not take a transaction with little or no relationship to the forum and apply the law of the forum in order to satisfy the procedural requirement that there be a 'common question of law' ". (*Id.* at 821). Constitutionally, a state court must have "significant aggregation of contacts", or "contacts creating state interests" to the claims asserted by each member of the plaintiff class for the forum to apply its laws. (*Id.* at p. 821).

While *Castano v. American Tobacco Company, supra*, involves a nation-wide products liability class action and the facts are distinguishable from the present case, the Fifth Circuit's

discussion on variations in state law is instructive. The court found that the class action movant has the burden of proof to show the variations in state law when a class action involves multiple jurisdictions (at p. 742). Citing *Walsh v. Ford Motors Co.* (807 F.2d 1000, 1017 [DC Cir 1986], *cert. denied*, 482 US 915 [1987]), the court noted it cannot accept plaintiffs' assertion "on faith" that there is no variation in state laws, and that "through an extensive analysis" of state law variances is needed. (*Id.*).

These cases are consistent with New York's choice-of-law principles, and the burdens of proof under CPLR § 901(a). Much like the test in *Shutts*, New York courts apply the laws of the state having the most significant contacts with the occurrence and with the parties. (*Babcock v. Jackson*, 12 NY2d 473, 482 [1963]; *Auten v. Auten*, 308 NY 155, 160 [1954]). As previously stated, CPLR § 901 (a) places the burden on the movant to show that its prerequisites have been met, (*Infra*, at p. 4), and to establish the identity of the class. (*Gottlieb v. March Shipping Passenger Servs.*, 67 AD2d 879 [1st Dept 1979]; *See also Katz v. NVF Co.*, *supra* 100 AD2d at 474; *Bloom v. Cunard Line Ltd.*, 76 AD2d 237, 240 [1st Dept 1980]). Not discounting that New York is arguably the financial capital of the United States, and where defendants do all or most of their business; plaintiffs' papers fail to support their own allegations that New York has significant contacts to *the class members' claims*.

As was recognized by plaintiffs, the contacts which must exist should be distinguished given that this case is for breach of fiduciary duty case, and is not a securities case. (Arizona Papers). Plaintiffs knew of 425,000 accounts existing in Arizona, and had some information about where defendants

transact their business on their customers accounts. However, instead of establishing the members' contacts, or where the claims accrued, they offer the defendants' papers submitted on their Arizona motion to dismiss for forum non convenience, where the focus was on the defendants and their contacts outside of the forum state. This does not demonstrates how these contacts connect to the class members and their claims.

Plaintiffs have admitted that "the same conflict of law issues would still need to be addressed . . . . by the court analyzing and applying the law of various jurisdictions[.]" (Pl. Resp. Motion to Dismiss, p. 8). Four state laws (New York, Maryland, Illinois, and California) have been identified in the choice of law provisions; and three other states are mentioned as where some of defendants' facilities are located. In this case, the court sees no reason why plaintiffs should not bear the burden of showing through a thorough conflict of law analysis that common questions of law predominate. Plaintiffs cite a single federal decision stating that there are no variations of state laws on breach of fiduciary duty, a couple of cases on unjust enrichment, and none of the states' applicable statutes of limitation. They have failed to substantially identify the legal issues under the state laws which may apply. In absence of such a record, this court cannot decide whether or not it is arbitrary or unfair to override the contract provisions, or whether New York law may apply to all claims. Therefore, plaintiffs have not shown that common questions of law predominate.

The typicality requirement of CPLR § 901 (a) (2) has not been satisfied because plaintiffs have not shown that their claims arise from a common course of conduct *and* that common questions of law predominate. (*See, Friar v. Vanguard Holding Corp., supra* 78 AD2d at 99; 2 Weinstein-Korn-Miller NY Civ

Prac ¶ 901.14). As was discussed above, while the claims are derived from the same course of conduct by the defendants, they have failed to show that New York's substantive law will be used in determining the rights of class members. (*Bittner v. Metropolitan life Ins. Co.*, NYLJ p. 27 col 6, J. Gammerman 12/19/94). Therefore, on this record, the court cannot find that their claims are substantially similar so as to satisfy the typicality requirement (*Compare, Weinberg, v. Hertz Corp.*, 116 AD2d 1 [1st Dept 1986]; *Brandon v. Chefetz, supra*, 106 AD2d 162 [1st Dept 1985]).

The adequacy of representation, under CPLR § 901 (a) (4), requires: (1) the representative plaintiffs will fairly and adequately protect the interests of the class — that is they are familiar with their claims and that they do not have substantial interests that are antagonistic to or conflict with those of the members of the class — and (2) the attorney for the class is qualified, experienced and generally able to conduct the litigation. (*In re Lilco Securities Litigation, supra*, 111 FRD at 672 [Ed NY 1986]; *Dura-Bilt Corp. v. Chase Manhattan Corp., supra*, 89 FRD at 102 [SD NY 1981]).

As plaintiffs correctly note, it is not required that they have any significant understanding of the legal or factual basis on which a complex case rests in order to maintain a class action. (*Dura-Bilt Corp. v. Chase Manhattan Corp., supra*). They must demonstrate a sufficient understanding of the nature of the case in order to vigorously pursue the prosecution of the litigation. Plaintiffs have shown that they have a basic understanding of the nature of this case and the financial resources to prosecute the litigation. However, plaintiffs' counsel's conclusory allegation that the named plaintiffs share substantially the same interests with that of the absent class members, without having

addressed whether their interests are consistent with those "entities" that they seek to represent is suspect at best.

Counsel for the plaintiffs have not made it at all clear who they seek to represent. That the class members are all account holder's and the customer of defendants is no basis on which this court can determine whether or not their interests are consistent. If these "entities" are institutional investors, their decision-makers may be influenced by considerations that would not affect individuals, or reach decisions which may be the product of an internal corporate compromise, and thus, what may be in the best interest of individuals may not be so for the corporate class members. (*See, In re Lilco Securities Litigation, supra; Hansberry v. Lee*, 311 US 32, 42 [1940]). But this is based purely speculation, since plaintiffs have failed to identify or describe how the class members' interests are consistent. Therefore, at this juncture, the court cannot find that plaintiffs have satisfied this requirement or shown that a class action is the superior method in reaching a disposition on theses claims.

Although plaintiffs allege, without demonstrating, that the class members' claims are small, it is conceivable that large entities, such as institutional investors may have sizeable claims. Again, plaintiffs' conclusory allegations do not address whether, in such event, the "economic reality dictates that [this] suit proceed as a class action at all . . . [because] the maximum damages recoverable by any single plaintiff [or class member] would be hardly enough to enable [it] to conduct to completion the protracted and complicated litigation to establish [its] claim." [cite omitted]. (*Gilman v. Merrill Lynch, Pierce, Fenner & Smith, supra*, 93 Misc.2d at 948).

Based upon the forgoing, this court finds plaintiffs have not satisfied all of the prerequisites of CPLR § 901(a). Depending on the facts developed, the plaintiffs may renew this motion, after appropriate discovery. Accordingly, plaintiffs' motion for class certification is denied without prejudice to renew.

The forgoing constitutes the decision and order of the court.

Dated: Sept. 26, 1996

ENTER

s/ Charles E. Ramos
J.S.C.

APPENDIX B — MOTION AND MEMORANDUM DECISION OF THE SUPREME COURT OF THE STATE OF NEW YORK, NEW YORK COUNTY IN *SANDRA BALLAN v. PRUDENTIAL SECURITIES, INC.* FILED JUNE 24, 1997

SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PRESENT: **Hon.** Herman Cahn ***Justice*** **PART 49**

INDEX NO. 122747/95

MOTION DATE 3/10/97

MOTION SEQ. NO. 002

MOTION CAL. NO. 3

SANDRA BALLAN

- v -

PRUDENTIAL SECURITIES, INC.

* * *

Upon the foregoing papers, it is ordered that this motion

[stamp] MOTION IS DECIDED IN ACCORDANCE WITH ACCOMPANYING MEMORANDUM DECISION IN MOTION SEQUENCE . . . . . .

Dated: 6/18/97

s/ Herman Kahn
J.S.C.

Check one: ☑ **FINAL DISPOSITION**
☐ **NON-FINAL DISPOSITION**

Appendix B

SUPREME COURT: NEW YORK COUNTY
IAS: PART 49

IN RE

PRUDENTIAL SECURITIES INC.
SWEEP LITIGATION

Index No. 122747/95

Seq. No. 002

CAHN, J:

This consolidated action arises from the alleged unlawful conduct of defendant Prudential Securities, Inc. ("Prudential") with respect to monies and free credit balances purportedly withheld from its customers for unduly long periods of time. Prudential moves for an order, pursuant to CPLR 3211(a) (1) and (7), 3013 and 3016(b), dismissing the complaint based upon documentary evidence, failure to state a cause of action, and failure to plead fraud with sufficient particularity. In addition, Prudential contends that a recent decision of the Appellate Division, First Department, entitled *The Estate of Braunstein v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, __ Ad2d __ [1st Dept. 1997], 657 NYS2d 12), which holds that state law claims against broker-dealers based upon their use of customer free credit balances are preempted by federal securities regulations, mandates the dismissal of plaintiffs' action.

In the securities industry, free credit balances are customers' funds held by brokerage firms which are subject to immediate cash payment to customers on demand, generally resulting from

sales of securities, dividends, interest, or other transaction. A "sweep" is generally the transfer of idle cash balances in customers' accounts into short-term income-generating investment vehicles such as money funds or bank short-term collective investment funds. In this action, plaintiffs claim that Prudential engaged in a practice of delaying the transfer of plaintiffs' free credit balances into money market funds for its own profit, and that such conduct constitutes an unjust enrichment, a breach of fiduciary duty, and a breach of the duty of good faith and fair dealing implied under its customer contracts.

On plaintiffs' own admission the only meaningful difference between this case and *Braunstein is* that here plaintiffs only sue one brokerage firm and in *Braunstein* plaintiffs sued several. The wrongs alleged in both cases are exactly the same. Therefore, *Braunstein is* determinative here, and plaintiffs' state claims are preempted by federal law. (See also, *Guice v. Charles Schwab* & Co., 89 NY2d 31 ([1996]).

In light of the foregoing the court need not and does not address that branch of defendant's motion to dismiss the complaint on state law grounds.

ORDERED that defendant's motion to dismiss is granted, and it is further

ORDERED that the Clerk is directed to enter judgment accordingly.

Dated: June 18, 1997

s/ Herman Cahn
J.S.C.

Supreme Court, U.S.
FILED
APR 17 1998
CLERK

No. 97-1491

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM 1997

THE ESTATE OF DAVID J. BRAUNSTEIN and ROSEMARIE BRAUNSTEIN, et al.,
Petitioners,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, et al.,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE COURT OF APPEALS
OF THE STATE OF NEW YORK

PETITIONERS' REPLY TO RESPONDENTS BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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TABLE OF CONTENTS

I. OVERVIEW OF RESPONDENTS' ARGUMENT 1

II. THE DIFFERENCES BETWEEN THE ORDER FLOW PAYMENTS AT ISSUE IN GUICE AND THE UNILATERAL USE OF FREE CREDIT BALANCES IN BRAUNSTEIN AS A CLAIMED "NECESSARY AND LEGITIMATE" MEANS OF CARRYING ON CUSTOMERS' BUSINESS 1

III. A COMPLETE ABSENCE OF CONGRESSIONAL AND SEC REGULATIONS REGARDING COMPENSATION TO CUSTOMERS FROM THE USE OF FREE CREDIT BALANCES DOES NOT EQUATE FEDERAL PREEMPTION NOR THE EXTINGUISHMENT OF ALL RIGHTS OF REDRESS 3

A. Right Of Redress 3

B. Absence Of Regulation v. Choice To Not Regulate 4

IV. RESPONDENTS ARGUMENT THAT EXPOSURE TO CIVIL LIABILITY FROM EACH STATE WOULD UPSET A FEDERALLY MANDATED BALANCE REGARDING THE USE OF FREE CREDIT BALANCES IS SPECIOUS 5

A. Respondents Argue That The Facts Of This Litigation Are Not Likely To Recur: There Will Be No Self-Regulation 7

B. Respondents Deny The Trust Relationship With Their Clients 8

V. THE COMMERCE CLAUSE DOES NOT APPLY TO THE CLAIMS ASSERTED HERE 9

VI. CONCLUSION 10

TABLE OF AUTHORITIES

Page

UNITED STATES SUPREME COURT CASES:

Freightliner Corporation, et al. v. Ben Myrick et ux. et al.,
514 U.S. 280, 115 S.Ct. 1483 (1995) 4

Leroy v. Great Western United Corporation,
443 U.S. 173 (1979) 8

Philips Petroleum v. Shutts,
427 U.S. 797 (1985) 7

Ray v. Atlantic-Richfield,
435 U.S. 151, 98 S.Ct. 988 (1978) 5

United States v. Mitchell,
463 U.S. 206, 103 S.Ct. 2972 9

West Lynn Creamery v. Healy,
512 U.S. 186, 114 S.Ct. 2205 (1994) 9

STATE CASES:

Gilman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,
101 Misc. 2d 655, 421 N.Y.S.2d 794
(S.Ct. N.Y. Co. 1979) and Id.,
93 Misc. 2d 941, 404 N.Y.S.2d 258
(Sup. Ct. N.Y. Co. 1978) 4, 9

Guice v. Schwab, et al.,
89 N.Y. 2d 31, 352 674 N.E. 2d 282,
651 N.Y.S. 2d 352, cert. denied,
117 S.Ct. 1250 (1997) 1

Steinbeck v. Gerosa,
4 N.Y.2d 302, 151 N.E.2d 170,
175 N.Y.S.2d 1, appeal dismissed,
358 U.S. 39 (1958) 6, 7, 10

TREATISES:

Regan, Siamese Essays: (I) CTS Corp. v. Dynamics Corp.
of America and Dormant Commerce Clause Doctrine;
(II) Extraterritorial State Legislation,
85 Mich. L. Rev. 1865 (1987) 9

CIRCUIT AND DISTRICT COURT DECISIONS:

Horst v. W.T. Cabe & Co.,
[1977-78 Transfer Binder] Fed.Sec.L.Rep.
(CCH) ¶96,213 (S.D.N.Y. October 31, 1977) 4

OTHER AUTHORITIES:

Payment for Order Flow, Exchange Act Release
No. 34902, [1994-95 Transfer Binder]
Fed.Sec.L.Rep. (CCH) ¶85,444,
at 85,854 n. 28 (Oct. 27, 1994)
("SEC Rel. No. 34-34902") 2

The Restatement (Second) of Trusts, §203 (1959) 9

SEC Rel. No, 34-18262, [1981 Transfer Binder]
Fed.Sec.L.Rep. (CCH) ¶25,134B
at 18,327 (Nov. 17, 1981) 4

Section 28(a) of the Securities Exchange Act of 1934
[15 USC §78bb(a) (1993)] 5

I. OVERVIEW OF RESPONDENTS' ARGUMENT

Respondents in their opposition to the Petition for Certiorari continue their fabled, smoke and mirror argument that federal regulation of "free credit balances" has:

> 1. Assured an efficient and economical system for the execution of securities transactions;
> 2. Accomplished certain objectives of Congress which establish a "coherent regulatory structure" for a national securities market system; and
> 3. Prevented the "upset [of] the policy-based delicate balances" that Congress has directed the SEC to achieve by regulation and structure of cost-effective and orderly securities market systems, citing as their main case Guice v. Schwab, et al., 89 N.Y. 2d 31, 352 674 N.E. 2d 282, 289, 651 N.Y.S. 2d 352, 359, c.d. 117 S.Ct. 1250 (1997) and additionally enhancing the Guice arguments with a tortured analyses of the history or "free credit balance" rule making.

In furtherance thereof, Respondents have tried to liken their linchpin case of Guice supra, which is a "disclosure" issue case, to the instant matter which has nothing to do with disclosure. (See Pet. for Cert., p. 16) It is difficult, if not impossible, to perceive any linkage between existing federal regulation or the history of such regulation and the unilateral arrogation by the Respondents of all of the benefits arising from the use of free credit balances as well as the simultaneous extinction of all state and federal civil remedies for such acts.

II. THE DIFFERENCES BETWEEN THE ORDER FLOW PAYMENTS AT ISSUE IN GUICE AND THE UNILATERAL USE OF FREE

CREDIT BALANCES IN BRAUNSTEIN AS A CLAIMED "NECESSARY AND LEGITIMATE" MEANS OF CARRYING ON CUSTOMERS' BUSINESS

Order Flow Payments are compensation for services rendered by one broker for another; those payments are consideration for the execution of security transactions. Order flow payments are inducements accepted by brokers from market makers (wholesale securities dealers) in exchange for directing customer order flow to the market maker. The breach alleged in the "order flow" and "best execution" cases akin to Guice arise from the broker-dealers' duty of "best execution," which is not implicated by the Braunstein claims. Payment for Order Flow, Exchange Act Release No. 34902, [1994-95 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶85,444, at 85,854 n. 28 (Oct. 27, 1994) ("SEC Rel. No. 34-34902").

Order flow payments are distinguished from free credit balances in several significant respects. Unlike free credit balances, order flow payments: (1) are directly related to the streamlining of procedures for the purchase and sale of securities; (2) are directly related to a broker's rate and commission structure -- an area over which the SEC has exclusive control; (3) have been the subject of continuous and extensive study by Congress and the NASD, as well as the SEC, which has expressly adopted a policy permitting the practice; and (4) are an "efficiency" vehicle to assist the "national market system for securities and . . . for the clearance and settlement of securities transactions," which was the purpose of Congressional amendments to the Securities Exchange Act in 1975. None of these factors exists here. Yet Respondents continue to argue that the unrestricted use for their own benefits of their customers' funds in some way has not only been sanctioned and blessed by the SEC, but additionally, they are prohibited by some SEC regulation from paying any benefits to the beneficiaries and owners of "free credit balances," i.e. those who have provided such funds.

They do argue - correctly - that there is "no provision for compensation to customers" of any broker-dealer income resulting from the usage of "free credit balances." (Resp. Brief at p. 13-14). Respondents also equate the permissive use of those balances as an absolute right to all of the fruits of such usage. Finally, they say that the SEC has been pervasive in its legislation and rule making in this regard - even though such a strident position contradicts their above referenced admission that there is "no provision for compensation to customers." All of this equates - Respondents say - to federal preemption when, in fact and law, it is a complete absence of federal control.

III. A COMPLETE ABSENCE OF CONGRESSIONAL AND SEC REGULATIONS REGARDING COMPENSATION TO CUSTOMERS FROM THE USE OF FREE CREDIT BALANCES DOES NOT EQUATE FEDERAL PREEMPTION NOR THE EXTINGUISHMENT OF ALL RIGHTS OF REDRESS

The usage of the benefits of Free Credit Balances have nothing to do with services performed by Respondents for anybody - except themselves; it is a double payment for Respondents' required brokerage functions which have already been paid for by the charging of commissions. The free, unfettered use of customers' funds has never been regarded by the SEC as an area to be regulated; it was always considered a matter between the customer and the broker and not a matter of regulatory concern. (Pet. App. S, A189-191 and App. T, A192-195, Petition for Certiorari). This "custom" hardly rise to the level of a "necessary and legitimate" means of carrying on customers' business as the Respondents have argued to this Court. (Resp. Brief, p. 8).

A. Right Of Redress

In Respondents' Opposition Memorandum their assertion

that common law claims relating to Respondents' profiting through the use of their customers' free credit balances are preempted by federal law is erroneous. Should the Court accept Respondents' position in this regard none of the customers of Respondents would have any right of redress for Respondents' breach of fiduciary duty and unjust enrichment in any court, federal or state.

On the one hand, there is no federal remedy since the SEC has consistently held that "the payment of interest by broker-dealers on free credit balances that arise as an incidence of customers securities activities is a business matter between a broker-dealer and its customers and normally will not raise regulatory concerns." SEC Rel. No, 34-18262, [1981 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶25,134B at 18,327 (Nov. 17, 1981) (Appendix S). On the other hand, according to Respondents the pervasiveness of the federal regulatory scheme would preclude any state claims. In such a scenario, the SEC's statement that money earned on a customer's free credit balance is a "business matter between a broker-dealer and its customers and normally will not raise regulatory concerns" would be superfluous. "Business matters" between a customer and a broker-dealer, including those relating to customers' free credit balances have traditionally been litigated at the state level. Horst v. W.T. Cabe & Co., [1977-78 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶96,213 (S.D.N.Y. October 31, 1977); Gilman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 101 Misc. 2d 655, 421 N.Y.S.2d 794 (S.Ct. N.Y. Co. 1979) and Id., 93 Misc. 2d 941, 404 N.Y.S.2d 258 (Sup. Ct. N.Y. Co. 1978). This was recognized by the SEC and any other interpretation would render meaningless the SEC pronouncements.

B. Absence Of Regulation v. Choice To Not Regulate

Respondents' alternate theory regarding preemption incorrectly draws a distinction between the absence of regulation as articulated in Freightliner Corporation, et al. v. Ben Myrick et ux, et al., 514 U.S. 280, 115 S.Ct. 1483 (1995) and a regulator's choice to not use the authority to regulate. The cases cited by

Respondents are inapposite both on the law and the facts. Contrary to Respondents' position, Ray v. Atlantic-Richfield, 435 U.S. 151, 178, 98 S.Ct. 988, 1004-1005 (1978) does not stand for a universal proposition that a federal agency's decision to not utilize its authority to regulate operates as an automatic preemption of state law. In fact, this Court has traditionally permitted a state to enforce laws that have a purpose different from the purpose of regulating behavior adopted at a federal level. Ray, 435 U.S. at 164, 98 S.Ct. at 998 ("the mere fact that a vessel has been inspected and found to comply with the Secretary's vessel safety regulations does not prevent a State or city from enforcing local laws having other purposes, such as a local smoke abatement law.") Petitioners' common law claims of unjust enrichment and breach of fiduciary duties are not in any way premised upon any federal regulation of behavior in regard to the brokerage industry's use and disclosure of free credit balances and do not conflict with any purpose of federal regulation.

Essentially, Ray and Respondents' other authorities have described a conflict preemption analysis which Petitioners have already addressed. Moreover, the SEC has not simply chosen to not regulate the profits earned by broker-dealers from their use of free credit balances, they have stated affirmatively such a use in a "business matter" between a broker-dealer and a customer "not of regulatory concern." This fits perfectly with the language of the savings clause of the 1934 Act which specifically authorizes state claims at common law and equity. (Section 28(a) of the Securities Exchange Act of 1934 [15 USC §78bb(a) (1993)]).

IV. RESPONDENTS ARGUMENT THAT EXPOSURE TO CIVIL LIABILITY FROM EACH STATE WOULD UPSET A FEDERALLY MANDATED BALANCE REGARDING THE USE OF FREE CREDIT BALANCES IS SPECIOUS

Respondents' arguments in the Arizona state court action

which was stayed in Arizona at their request, vigorously pointed out that New York law - the reason for the need of New York venue - would apply to the subject transactions. A summary of those arguments regarding the Respondents' choice of law provisions in their stay or transfer motion follows:

Defendant (Respondents)	State of Incorporation	Defendants' (Respondents) Principal Place of Business and Choice of Law and Forum
Shearson	Delaware	New York
Kemper	Delaware	New York or Illinois
Smith Barney	Delaware	New York
Lehman Brothers	Delaware	New York
Prudential Bache	Delaware	New York
Paine Webber	Delaware	New York
Merrill Lynch	Delaware	New York
Kidder, Peabody	Delaware	New York
Dean Witter	Delaware	New York
Bear Stearns	Delaware	New York
Alex. Brown	Maryland	New York or Maryland
Charles Schwab	California	New York or California

Respondents' argument that should Petitioners' claims be given viability, an "undermining" of one "finely crafted" and "balanced" Federal regulatory structure would occur because each state would impose differing standards of liability, is transparent and illusory. Respondents should not be allowed an unlimited franchise in regard to free credit balances as Petitioners' contacts with New York clearly permit regulation of such commerce. Steinbeck v. Gerosa, 4 N.Y.2d 302, 319-20, 151 N.E.2d 170, 180,

175 N.Y.S.2d 1, 14-15, appeal dismissed, 358 U.S. 39 (1958) (rejecting Commerce Clause challenge to City's General Receipts Tax on residents). Indeed, Petitioners' contacts with New York clearly permit application of a unitary body of law to these claims. This court has endorsed such a procedure in national class actions. Philips Petroleum v. Shutts, 427 U.S. 797 (1985).

Finally, these claims of Petitioners in no way attempts to regulate Respondents' behavior. Respondents can proceed with their day to day business even though common law claims of unjust enrichment and breach of fiduciary duty are given viability.

A. Respondents Argue That The Facts Of This Litigation Are Not Likely To Recur: There Will Be No Self-Regulation

After pointing out the difficulty that rights of redress would cause to them if permitted, the Respondents then say they are discontinuing the practice due to some vague economic pressure or reform and that, further, they have no fiduciary duty to their customers.

Respondents claim that the practices for which the Petitioners seek redress are of "limited scope" and "decreasing practical importance" due to reforms in the brokerage industry. According to the Respondents, broker dealers now offer "sweep" accounts which automatically invest free credit balances in money market funds. In fact, these "sweep" accounts are computerized to permit at least an overnight delay, if not more; Petitioners have so alleged. However, the facts are not limited only to "sweep" accounts. The problems of delay of payment of cash funds to customers occurs in all transactions involving the collection by the broker of dividends, interest and proceeds from security transactions. The unilateral usage of free credit balances is at its greatest during the transaction wherein an account is transferred from one broker to another even though funds could be wired instantaneously. Petitioners have alleged these various techniques

including the "sweep" one-day delay practice or intentional delays in their Amended Complaint. (Pet. for Cert., A50-83). These claims of self-regulation by the brokerage industry are fantasies even if true do not compensate the public for past practices. Far from being of limited scope, the practice of using free credit balances encompass millions, if not billions, in improper profits made at the expense of tens of millions of securities customers (Pet. App. G at A55-56, 60). In fact virtually every account of the 30,000,000 accounts handled by the Respondents has been damaged whenever a free credit balance was created as a result of a securities transaction. (Pet. App. G at A51-53 and A63-66). This practice has not only been acknowledged by Respondents; it was proudly stated in their Memorandum in Opposition to Class Certification:

> "[T]he long-standing industry practice was not to pay benefits earned on free credit balances to the customer." (Pet. App. BB at A216).

Petitioners seek protection from such wide spread practices past, present and future as well as the payment of damages through enforcement of state securities laws and claims; Section 28(a) leaves the several states authority in this regard. Leroy v. Great Western United Corporation, 443 U.S. 173, 182 f.n. 13.

B. Respondents Deny The Trust Relationship With Their Clients

The Respondents make the argument that the broker acts not as a trustee for the customer's free credit balances, but rather as a debtor to the creditor (i.e., customer). Neither the Appellate Division nor the Court of Appeals addressed the trust issue; instead, only constitutional issues were addressed. Thus Judge Schackman's decision following established New York and state law generally stating that a trust relationship exists, should stand. But even if, for the sake of argument, the Respondents' position is considered, it does not stand up to close scrutiny. The Respondents' contention - that the practice of using free credit

balances is not a trust relationship - flies in the face of the universal belief of the courts, legal writers and the public. See Gilman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 101 Misc. 2d 655, 421 N.Y.S.2d 794 (S.Ct. N.Y. Co. 1979) and Id., 93 Misc. 2d 941, 404 N.Y.S.2d 258 (Sup. Ct. N.Y. Co. 1978). For example, The Restatement (Second) of Trusts, §203 (1959) (Pet. App. DD at A240-241) states clearly:

> ". . . (a) trustee is accountable for any profit made by him arising out of the administration of the trust, regardless of whether he entered into the transaction with the intent of making a profit for himself or not, and regardless of the fact that he commits no breach of the trust in so doing."

Moreover, this Court in United States v. Mitchell, 463 U.S. 206 at 225, 103 S.Ct. 2972 recognized the unassailable principle that "a trustee is accountable in damages for breaches of trust." This concept has remarkably escaped the securities industry's treatment and perception of free credit balances; it should not be allowed to continue.

V. THE COMMERCE CLAUSE DOES NOT APPLY TO THE CLAIMS ASSERTED HERE

Even under a "traditional" commerce clause analysis, Defendants' argument must fail. The Commerce Clause was intended to "prohibit economic protectionism -- that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors." West Lynn Creamery v. Healy, 512 U.S. 186, 114 S.Ct. 2205, 2211 (1994). This Court has never suggested that the Commerce Clause requires each state's law to stop at its border. Regan, Siamese Essays: (I) CTS Corp. v. Dynamics Corp. of America and Dormant Commerce Clause Doctrine; (II) Extraterritorial State Legislation, 85 Mich. L. Rev. 1865, 1878 (1987) ("prohibition [of all state laws that have substantial extraterritorial effects] would invalidate too much

legislation").

The retention of the benefits arising from their use of free credit balances, are not transactions that implicate interstate commerce and, thus, do not fall within the protection of the commerce clause. These activities are separate and distinct from any interstate securities transactions which might be protected by the Commerce Clause. Free credit balances arise as *an incidence of* securities transactions, but are not necessary to their execution. As one New York court has said, "if it can be said to affect interstate commerce in any way it is incidentally, and so remotely as not to amount to a regulation of such commerce." Steinbeck, 4 N.Y.2d at 319-20, 151 N.E.2d at 180, 175 N.Y.S.2d at 14-15, appeal dismissed, 358 U.S. 39 (1958).

VI. CONCLUSION

For the reasons stated in the Petition for Certiorari and in this Reply Brief, Petitioners request the Court to grant said Petition.

Dated: April 17, 1998

Respectfully submitted,

/s/_____

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